Sunniva Inc.

Second Quarter 2018 Earnings

Conference Call Transcript

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Speakers:

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

Leith Pedersen
Co-founder and President

David Negus
Chief Financial Officer

Robert Knowles
Vice President, Corporate Development

Operator:

Welcome to the Sunniva Inc. Second 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.

Robert Knowles:

Good morning. Thanks everyone for joining us this morning to discuss our results for the second quarter of 2018. My name is Rob Knowles and I am the Vice President of Corporate Development for Sunniva, Inc. With me today are Dr. Anthony Holler, our Co-founder, Chairman and Chief Executive Officer; Leith Pedersen, our Co-founder and President; and David Negus, our Chief Financial Officer. We hope you have had an opportunity to review the news release, MD&A and financial statements we issued yesterday, August 29, 2018.

Let me quickly outline the agenda for today's call. Dr. Holler will provide an introduction, then provide a strategic and operational update, followed by our CFO David Negus who will provide a financial overview, and then we will 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 known and unknown risks and uncertainties including, but not limited to, those factors set forth in yesterday's news release, our MD&A and other public disclosure documents which are available on the SEDAR website. These risks and uncertainties could cause actual future results to differ 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.

Anthony Holler:
Thank you, Rob. Good morning everyone, and thank you for joining us today to talk about our second quarter results of Fiscal 2018. Today I will speak to where we are strategically, update you on the key milestones achieved and report on some exciting developments at the Company.

We made great progress in Q2 towards our goal of becoming a vertically integrated cannabis company in the U.S. In California, construction progressed on our Phase 1, 325,000 square foot state-of-the-art Sunniva California Campus in Cathedral City, which is expected to be operational by the end of this year, and first harvest expected in Q1 2019. Our extraction facility, also in Cathedral City, we began generating revenue this quarter. We continue to secure new contracts and are excited about the future revenue opportunities in this and other vertical channels that maximize the synergies with our device business, Full-Scale Distributors, or FSD.

Our focus in California and the U.S. is to leverage our cultivation and extraction facilities and aggressively pursue upstream distribution and retail opportunities to achieve full vertical integration from seed to sale, which will include a focus on launching Sunniva-branded product lines in various product categories including flower, extracted products, vaporizers and beverages.

In Canada, we received our Confirmation of Readiness letter for a licence from Health Canada and broke ground and commenced construction on the 759,000 square Sunniva Canada Campus in Okanagan Falls, British Columbia. Our Natural Health Services clinics, or NHS, reported another strong quarter of revenue generation, and together with the future production from the Sunniva Canada Campus, provide a solid foundation for future Canadian growth opportunities.

During the second quarter of Fiscal 2018, we have taken major steps forward on a number of key fronts in executing our business strategy. The Confirmation of Readiness letter for a licence under the Access to Cannabis for Medical Purposes regulations from Health Canada represents acceptance of the Company’s detailed application with the next step being an inspection upon site readiness in order to commence cultivation. We had the grand opening of our seventh patient-centric NHS clinic in Windsor, Ontario. We have completed the acquisition of the 126 acre industrial zoned property for the Sunniva Canada Campus in Okanagan Falls, British Columbia for a purchase price of $7 million. The transaction closed on June 15, 2018, for consideration of $3.5 million in cash and the balance through a one-year vendor take-back mortgage financing arrangement.

We secured 12-month extraction services agreements with two leading California cannabis brands, Cali Gold and Farmacy Factory, for the extraction facility in California that became operational in the quarter.

Now looking ahead to the key business objectives for the remainder of 2018, in the cultivation space, we expect Phase 1 of the Sunniva California Campus to be operational in Q4 2018 with first harvest coming in Q1 2019. We have submitted all of our annual state licence applications for our facilities. Phase 1 is expected to ramp up to an annual rate of 60,000 kilograms of flower and trim. We are currently in discussions with distributors and brands with the goal of executing supply agreements for dry product and extracted products from our Cathedral City facility. We will have significant first mover advantage in California. We will be the first operational large-scale facility producing cannabis free of pesticides and other harmful contaminants. It is currently estimated that approximately 85 percent of cannabis products sold in California today contain pesticides and other potentially harmful contaminants.

We have commenced construction on the Sunniva Canada Campus. Grading of the site is expected to be 100% complete by mid-September. Foundation work on Phase 1 has commenced and is approximately 40% complete.

In our other value-added business units, we continue our focus on FSD revenue growth. Revenue expansion by FSD is anticipated from the continued development of custom, private label vaporizers and cartridges, resulting in an expanded customer base. We continue to execute our NHS business plan to expand our patient base and doctor network with the addition of the Windsor clinic. NHS operates seven clinics in four provinces specializing in medical cannabis. These clinics are operated by in-house physicians, nurse practitioners and support staff who provide expert consultation, education and recommendations for patients. NHS is leveraging its physicians and its proprietary SPARK software beyond its bricks and mortar facilities by attracting more physicians and working with pharmacy partners.

The global cannabis industry continues to evolve on a daily basis. We are happy with the progress we have made this quarter in both our operational areas and are excited about the prospects in each. The 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 our Sunniva California Campus. We are excited about the landscape and look forward to further expansion in California.

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. I will now outline the details of our second quarter 2018 results. For the second quarter of 2018 revenue increased 36% to $4.5 million from $3.3 million in the comparative second quarter of 2017. The increase in revenue was driven by an increase in clinics and corresponding patients at NHS from four locations in the second quarter of 2017 to seven locations in the second quarter of 2018. As a result, NHS revenue increased 30% to $3.2 million from the comparative period in 2017. Merchandise revenue from FSD increased 55% to $1.3 million from the comparative period in 2017 due to an increased customer base and more consistent sales from key customers. Compared to the first quarter of 2018, total revenue decreased 13% due to the seasonality of ordering FSD merchandise from Chinese New Year factory closures.

FSD revenue decreased 49% or $1.2 million from the first quarter of 2018. This was offset by an increase in NHS revenue up 20% or $0.5 million due to additional contracts with licenced producers. NHS and FSD represented 71% and 29% of total revenue, respectively, in the second quarter of Fiscal 2018 compared to 75% and 25%, respectively, in the second quarter of Fiscal 2017.

Gross margin in the second quarter of 2018 was $2.8 million or 62% of net revenue compared to $1.2 million or 38% of net revenue in the same period last year. The primary driver of this increase was licenced producer revenue at NHS. This revenue stream was $1.5 million higher in the second quarter of Fiscal 2018 compared to the same period in Fiscal 2017 and incurs minimal direct costs.

SG&A expenses were $5 million or 111% of net revenue compared with $3 million for the same period last year. The increase of $2 million in SG&A is primarily due to an increase in professional and other fees of $750,000 in support of the growth of the Company and business development activities, an increased employee-related cost of $700,000 due to our expansion in both Canada and the United States as we continue building a team to fulfill the Company's longer-term strategic objectives, and an increase in facilities cost of $450,000 with three new clinic locations across Canada and a new Head Office for Sunniva in Vancouver, British Columbia.

Non-cash operating expenses were $2.7 million, or 59% of net revenue, compared to $0.7 million or 21% of net revenue from the same period last year. The $2 million increase is due to an increase of $1.9 million in share-based payment expense from stock option plan that came into effect in Q2 2017, and an increase in amortization and depreciation expense of $100,000 due to depreciation on newly acquired capital assets. As a result, the operating loss for the second quarter of Fiscal 2018 was $4.8 million or 107% of net revenue compared with an operating loss of $2.5 million or 76% of net revenue for the same period last year.

During the second quarter of Fiscal 2018, the Company realized a non-cash gain of $540,000 resulting from a fair value decrease in its warrant liability compared to a loss of $8.9 million in Fiscal 2017.

Foreign exchange loss in the second quarter of Fiscal 2018 was $183,000 compared to a foreign exchange gain of $275,000 in Fiscal 2017.

Deferred tax recovery in the second quarter of Fiscal 2018 was $4,000 compared to $336,000 in the second quarter of Fiscal 2017. This difference is due to stronger results in NHS that limited the amount of recovery we could take for tax purposes. As a result, net loss was $4.9 million or $0.16 per share in the second quarter of Fiscal 2018 compared to a net loss of $10.7 million or $0.42 per share for the second quarter of Fiscal 2017.

Turning to highlights of our year-to-date performance, net revenue increased 70% to $9.6 million for the first six months of Fiscal 2018 from $5.7 million in the same period of Fiscal 2017. During the first two quarters of Fiscal 2018, gross margin was $4.9 million or 51% of net revenue compared to $2.5 million or 43% of net revenue in Fiscal 2017. Net loss for the six months ended June 30, 2018 was $11.2 million or $0.38 per share compared to $11.7 million or $0.48 per share for Fiscal 2017.

Looking at our balance sheet highlights, we ended the quarter with $22 million in current assets versus $14.5 million in current assets at December 31, 2017, and had a working capital surplus of $10.9 million versus a deficit of $1.2 million at December 31, 2017.

During the second quarter of Fiscal 2018, we received $8.9 million in proceeds from financing, primarily due to the exercise of warrants and the receipt of a mortgage for the purchase of our facility in OK Falls.

During the quarter, $16.5 million was invested in CapEx and $4.6 million was utilized in building our working capital and funding operating losses.

Cash and cash equivalents as at June 30, 2018 was $17.5 million.

The Company's current cash position as of today is approximately $11.9 million. We continue our discussions regarding financing of the Sunniva Canada Campus with a variety of financial institutions.

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

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 are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star, then two. Once again, to join the question queue, please press star, then one. We will pause for a moment as callers join the queue.

Our first question comes from Matt Bottomley of Canaccord Genuity.

Matt Bottomley:
Hey guys, good morning.

Anthony Holler:
Good morning, Matt.

Matt Bottomley:

I hope all is well. So, just a couple of questions on my end. Maybe first just a general California market update. What are the regulators doing over the last month, or I should say since July 1, with respect to maybe clamping down a bit on product that's either contaminated or not compliant with the new regulations? Are we seeing that acceleration in terms of enforcement, and on top of that, is that bringing interested parties to you to ask when your facility—and I know you have telegraphed here, it will be ready up for Q1, but are you seeing more demand for potential onboarding of contracts in the last few months?

Anthony Holler:

We definitely have seen an increase in the number of brands requesting clean product. That's something that's been happening over the last few months. In terms of enforcement in California, I think what we've heard is that they are sending out letters to noncompliant growers, dispensaries, etc. We haven't seen any actual enforcement where they shut down operations, but I think that's going to happen in the future. I think this enforcement is going to take some time before it has effect, but I am telling you that all the compliant operators, whether they are distributors or dispensaries, they have a problem right now and that's getting compliant product. Remember also that in the near term we are going to start seeing all products having to go through testing to make sure that they are compliant, so I think this issue is going to become a bigger and bigger issue and that's why we are so excited about our facility and getting into business, as you know, in the first quarter of next year.

Matt Bottomley:

Appreciate that. Next, just on the extraction contracts, I know you likely not going to give any specific guidance, but can you give us any view on just the overall general magnitude of what to expect in the next couple of quarters as those two relationships you have onboard, is this something that is material to your current $5 million a quarter run rate, or is it something less than that?

Anthony Holler:

It certainly could be very material. The issue we have at the extraction facility is that right now, because our Sunniva Campus isn't growing product, we have to access clean trim to make these extracted products. We're having some success and our reputation is growing, so I think this could be very material to our revenues, but again, there are complications such as acquiring product that's clean.

Matt Bottomley:

Okay. I guess the contracts you have right now, there's no issues fulfilling those. Like, are you able to source clean product to satisfy the two contracts you currently have?

Anthony Holler:

Yes.

Matt Bottomley:

Okay. Okay, great. Last just question on my end, just with respect to your Canadian buildouts, I know you have financing arrangements in place for the California ops. How funded are you to get the Canadian facility to the goal line, and if not, when do you expect you will need to consider financing options in Canada?

David Negus:

We continue to work with our lending partners and we are talking with a variety of financial institutions in funding that Canadian facility. That's our status right now and we continue to work towards that.

Matt Bottomley:

Okay, guys. Thanks a lot. Appreciate it.

David Negus:

Thank you.

Operator:

Our next question comes from Anthony de Ruijter of Fundamental Research Corp.

Anthony de Ruijter:

Good morning gentlemen.

Anthony Holler:

Good morning.

Leith Pedersen:
Good morning.

Anthony de Ruijter:
I won’t take too much of your time today, just a few questions. The first couple are to do with the general market and sort of how it impacts NHS, and then the extraction contracts announced in the quarter. First question is, if you have been keeping tabs on the ACMPR data, registrations have slowed in recent times and there is a lot of takeaways from that; it could be the maturity of the program etc., etc. One of the things that I theorize is there’s somewhat a degree of substitution between recreational cannabis and medical cannabis for people in Canada who want to access cannabis, and seeing as it’s going to be—sorry, recreational cannabis will be legalized on October 17th, sort of I’ve come to the conclusion that perhaps a lot of people are simply waiting for it to become widespread, legally widespread throughout the nation. Perhaps you could give me some guidance on how that might affect NHS if the medical market starts to slow down?

David Negus:
Anthony, I could see that on a national basis. We continue to grow our NHS patient base, and I think the differentiator in our business compared to the national marketplace is our emphasis on education. As you know, we have invested a lot in education through our affiliate—through our clinics and our affiliate partners, and that is what continues to drive patients through our doors. I think that’s a big difference for our business.

Nationally, I think you are going to find that for some folks it’s easier to go directly to recreational, but we all believe that there is a large medical patient base out there that is looking for valued education and resources in order to use cannabis for all of their medical needs and we think we are right there with that consumer.

Anthony Holler:
Anthony, there has been some estimates that they are up to 2 million patients in Canada who could benefit from cannabis use and that includes people with—the elderly with sleep disorders, arthritis, all these things. Right now, remember that probably what limits medical patients is the fact that it’s so difficult to get registered as a medical patient. We’re one of—there are a number of clinic groups that are registering patients, but again, they are small number compared to the need,

so I think you are going to see the expansion of the medical patients. Also remember that in Canada, with the prescription or a recommendation from a physician, the costs of your cannabis are a legitimate expense on your income tax return. I think all of those things tell me that we are going to see a growth in the medical patient group in the future.

Anthony de Ruijter:
Yes, that's totally fair. That's a great answer. Also one thing I should have commented is that we have yet to see insurers come into the space and if they do we could definitely see a boom in the ACMPR moving forward, but one of the greatest sources of NHS' revenue are LPs. Maybe you could comment on the likelihood of LPs to stay with the NHS program once recreational boom starts?

David Negus:
I think that will continue, Anthony. We have strong relationships with our LP partners because of our ability to offer our patients variety in different products. There are many different products being offered by LPs out in the marketplace, and it goes back to our education strength and our relationship with our patients. Being able to educate them on the different products that are provided by the LPs is a value to not only our LPs, but to our patients. Our ability to continue to offer variety, to continue to educate is what's going to differentiate us in the marketplace. Now, together with our LP partners, as you know, we will also introduce Sunniva-based products and we will continue to grow the assortment of products that we can provide to our patients.

Anthony Holler:
Anthony, the only thing I would add to that is that if you look at the recreational adult use market, that's a wholesale market that basically the licenced producers go through a provincial government agency, so it's a wholesale market. A medical patient who comes from us is a much more valuable patient to the LP; heir margins are much larger on that patient than a recreational user.

Anthony de Ruijter:
Okay, fantastic. All right, last couple of questions then. Looking at the extraction contracts announced in the quarter, with regards to timing, will we see the impact of that in next quarter's financials, and if you could comment at all on the margins of the contract and how that might be improved once your own supply in California comes into place?

David Negus:
I think, Anthony, we are not providing guidance on margins at this time. We will have some extraction revenue in Q3, but we are looking for some significant amounts of extraction revenue in Q4.

Anthony de Ruijter:
Okay, excellent. Last question then—and just the general one—are there any updates to the production schedule from either the Sunniva Campuses? For example, we had estimated a Q4 buildout and in this quarter's financials has revealed that it's more going to be Q1 2019. How is the build out of the Canada Campus coming along?

Anthony Holler:
Canada is moving along. You can go onto the website and see the construction in progress. As we get closer to the opening dates in the United States, obviously we are refining those dates and we are getting—we are counting down, instead of months, we are counting down days, so you can see us today providing guidance that we'll have a first planting in the United States in Q4 and first harvest in Q1.

Anthony de Ruijter:
Okay, fantastic. Thanks for your answers, gentlemen. Very enlightening. Have a good day.

David Negus:
Thank you, Anthony.

Anthony Holler:
Thanks, Anthony.

Operator:
Once again, if you have a question, please press star, then one.

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

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 are staying focused on building out our California Campus and Canada Campus through 2018, as this will not only drive our revenue growth through 2019 and beyond, but will enable us to continue to leverage our cultivation and extraction facilities to pursue our goal of full vertical integration from seed to sale. Thank you very much for joining the call.

Operator:

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