Corrected Transcript

14-Feb-2020

Canopy Growth Corp. (WEED.CA)

Q3 2020 Earnings Call

CORPORATE PARTICIPANTS

Judy Hong
Vice President-Investor Relations, Canopy Growth Corp.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

OTHER PARTICIPANTS

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Glenn G. Mattson
Analyst, Ladenburg Thalmann & Co., Inc.

Vivien Azer
Analyst, Cowen and Company, LLC

Adam Buckham
Analyst, Scotia Capital, Inc.

W. Andrew Carter
Analyst, Stifel, Nicolaus & Co., Inc.

John Zamparo
Analyst, CIBC World Markets, Inc.

Michael S. Lavery
Analyst, Piper Sandler Companies

Aaron Grey
Analyst, Alliance Global Partners

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Graeme Kreindler
Analyst, Eight Capital

Owen Bennett
Analyst, Jefferies LLC

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Jason Zandberg
Analyst, PI Financial Corp.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Endri Leno
Analyst, National Bank Financial, Inc.

Chris Blake
Analyst, Laurentian Bank Securities, Inc.

John Chu
Analyst, Desjardins Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name Dianna and I will be your conference operator today. I would like to welcome you to Canopy Growth's Third Quarter Fiscal 2020 Financial Results Conference Call. At this time, all participants are in a listen-only mode.

I will now turn the call over to Judy Hong, Vice President, Investor Relations. Judy, you may begin the conference call.

Judy Hong

Vice President-Investor Relations, Canopy Growth Corp.

Thank you, and good morning, everyone. We're glad that you have taken the time to join our third quarter fiscal 2020 financial results conference call. On our call today, we have David Klein, our CEO; and Mike Lee, our CFO.

Before the markets open today we issued a news release announcing our financial results for our third quarter fiscal 2020 ended December 31, 2019. This news release is available on Canopy Growth's website and has been filed on SEDAR.

Certain matters discussed in today's call or answers that may be given to questions could constitute forward-looking statements. Actual results could differ materially from those anticipated. Risk factors that could affect results are detailed in the company's annual information form and other public filings that are available on SEDAR.

During the call, we will refer to supplemental non-GAAP measures, adjusted EBITDA and free cash flow. Adjusted EBITDA and free cash are defined in the press release issued this morning, as well as this period's management's discussion and analysis document filed on SEDAR.

Please note that all financial information is provided in Canadian dollars unless otherwise noted. Following prepared comments by David and Mike, we will conduct a Q&A session. To ensure that we get to as many questions as possible, we ask the analysts to limit themselves to one question.

With that, I'll now turn the call over to David. David?

David Eric Klein

Chief Executive Officer & Director, Canopy Growth Corp.

Thank you, Judy, and good morning everyone. I'm very excited to be on this, my first earnings call as CEO of Canopy Growth. To begin my remarks, I'll offer a perspective on why I decided to join Canopy.

First, I believe the cannabis market is one of the most exciting business growth opportunities of our lifetime. We are taking part in the creation of a new regulated consumer market, the likes of which we have never seen. Second, having been an early advocate of Constellation Brands' investment in Canopy Growth, and having been on the Board since October 2018, I firmly believe Canopy is well-positioned to win in the global cannabis market. We have a leading market share in the recreational market in Canada, and a strong position in the medical market in both Canada and abroad. Additionally, I believe Canopy has the opportunity to create an unassailable global position in cannabis.

Canopy possesses excellent knowhow, industry experience, intellectual property and talent. The combination of these assets has the ability to set us apart from the competition. Another asset of Canopy's that cannot be overlooked is the strength of our balance sheet. In a sector where capital is becoming increasingly costly, if it's available at all, the value of having CAD 2.3 billion in cash cannot be understated. Our job is to nurture this strength and ensure that we build a profitable, world class company with brands that consumers trust.

Now, I know you'll have many questions about what I'm planning to do, especially in light of what's going on in our industry. Make no mistake, we have a lot of work to do. I'll detail our path forward during our fourth quarter earnings call once I've completed my assessment. However, you can be assured that I am, along with the management team, already taking actions that will keep us in the leadership position of the cannabis industry.

For now, let me highlight my key priorities. My first priority will be improving Canopy Growth's connection with our consumers. The winner in this market will possess the brands that are most trusted and most loved by our consumers. We will leverage our consumer insights, intellectual property and production capability to consistently deliver consumer preferred products that deliver the best quality at each price point.

My second priority is bringing more focus and discipline to our organization. As this new nascent industry developed over the past five years, playing across the board made sense due to uncertainty about industry direction. The industry however, has evolved and we now need to focus on specific markets and product brands, where we have the legitimate right to win. This means deciding where we won't play as well as where we will.

My third priority is to define a very visible path to profitability and positive cash flow. This means we need to align our resources and investments with the size and growth rate of the market as it exists today. We've began taking steps designed to bring our inventory in balance with our supply/demand forecast, this includes a thorough strategic review of our footprint, which is underway. Mindful of future market growth, we're prepared to take initial steps to right-size our business over the next 90 days.

My final priority is building the company and management's credibility with all stakeholders. We will do this by delivering on our commitments in a thoughtful and measured fashion.

Let me now briefly cover some business highlights. First, the Canadian recreational market. Overall consumer demand remains strong and Canopy continues to hold a leading market share in recreational cannabis markets across the country. At retail and using data published by provincial agencies and StatsCan, Canopy is number one in Nova Scotia, number one in Prince Edward Island, and number two in Ontario.

In Alberta, the country's most developed market, Canopy continues to hold the number one spot, accounting for roughly 30% of the market. Our same-store retail sales increased 11% on a quarter-over-quarter basis. Sales of dried flower remain strong across our price ranges. Notably, strong demand continued for our value price TWD strain, as well as for premium strains.

Moving to medical cannabis markets. We are seeing our sales increase in the Canadian medical market, thanks in part to a growing customer base. It's notable that sales of oil and soft gels account for over 60% of our Canadian medical sales. We're encouraged by the progress we're making in key European markets with strong sales in Germany.

In the US market, we achieved an important milestone with online sales of First & Free branded hemp-derived CBD products beginning in December 2019. I am excited about the US market opportunity. Providing Canopy with the resources to enter the US market was a key driver of Constellation's most recent investment

That said, we recognize that we want to and need to move faster and make bolder moves in the US. We're focused on creating brands that resonate with our consumers and making sure we can get distribution of our products in places where our consumers can legally purchase them.

Now, before I hand the call over to Mike, I'd like to provide an update on our Cannabis 2.0 launch in Canada. Since the very beginning of our 2.0 product development, Canopy has been committed to bringing the highest quality, most differentiated products to market. We believe this is the best business approach to win over the long-term.

Our first edible products, premium chocolate products, shipped out of our Smith Falls facility in December 2019. Multiple products, Tokyo Smoke Go, Tokyo Smoke Pause, and Tweed Bakerstreet, entered the market in December and have been selling out very quickly. Our next offering, Bean & Bud, is on track to be in market late February, with additional SKUs following in the first quarter of fiscal 2021.

For our vape product offering, we focused on delivering products with differentiated levels of safety, functionality, and design. All of our products will meet Underwriter (sic) [Underwriters] Laboratories, or UL 8139 safety standards. Our JUJU Power, the sector's only UL 8139 certified rechargeable battery for 510 cartridges began shipping in December and entered the market in early January 2020. We're seeing strong demand for these devices.

For our 510 cartridges and proprietary pod based Tokyo Smoke Luma, we expect to be in market over the next few months. Now, this is later than we previously communicated, but we felt our highest priority is to ensure that we provide our consumers with the highest quality and safest products possible, even if it means delays to our in-market dates.

Lastly, Canopy has long believed in the low-calorie, high quality cannabis beverages that rival alcohol beverages in the taste and social experience they deliver would create a new consumer segment and expand the overall cannabis category. Leveraging considerable intellectual property, Canopy has formulated a range of beverages that I believe will delight our consumers. I know some of you had a chance to taste the non-active version of our products, but let me say this; the active versions are a whole new ballgame.

To add some color here, a few weeks ago, myself and other Board members tasted live versions of our cannabis beverages. After the tasting, a fellow Board member sent me a text; the text read simply, game-changer. I share that opinion. In our view, we truly have a unique and differentiated beverage which, based on our competitive tasting, you can't find anywhere.

We also see our cannabis beverage as truly disruptive and the best vehicle to attract new consumers to the cannabis market. In other words, we believe it will do more to recruit new consumers than any other product format in our industry, creating new consumption occasions, and a whole new industry. Just think about how big hard seltzers in the US became in just three years. So, we are going to take the next few months to get it right and ensure that we can introduce our consumers of today and of the future to a true game-changer.

Lastly, and relatedly, I would like to take a brief moment to acknowledge and applaud the Ontario government's recent initiation of public consultation on providing consumers with more choice and convenience on cannabis and business opportunities, including consumption venues. The consultation is the first major milestone that's required to move forward with providing Ontarians with safe, convenient access to regulated cannabis, while providing more support for private sector business opportunities.

This concludes my remarks, and I'll now pass the call over to Mike to review our third quarter fiscal year 2020 financial results in greater detail.

Mike Lee

Chief Financial Officer, Canopy Growth Corp.

Great. Thanks, David. Good morning, everyone. Let me begin my remarks with a brief review of the progress that we made during our third quarter of fiscal 2020. Total net revenue grew 13%, excluding the impact of portfolio restructuring charges last quarter. Our business generated gross margins of 34% before fair value impacts. Total SG&A decreased 14% quarter-over-quarter, and adjusted EBITDA came in at a loss of CAD 92 million compared to a loss of CAD 156 million last quarter.

I will now move on to a more detailed review of select items. Our top line performance benefited from a broad base of growth in our core cannabis business, as well as our strategic acquisitions. Here are a few highlights. Canada recreational revenue increased 10%, benefiting from balanced growth across our B2B and B2C channels, and we are pleased with the growth of flower sales, which were driven in part by higher sales of premium strains and a greater than 50% increase in the sales of pre-rolled joints. Our B2C revenue increased 16% over prior quarter, due in part to 11% increase in same-store sales.

Canadian medical sales increased by 5% quarter-over-quarter, driven in part by an increase in the number of customers to over 76,700. International medical increased 3% quarter-over-quarter, as our sales in Germany benefited from opportunistic sales to fill supply gaps created by a regulatory hold on products of another vendor.

Revenue generated by C3 increased by 5% over the prior quarter, driven by continued growth and demand for the cannabinoid-based therapies. And over the past year, Canopy has made a number of strategic acquisitions that are performing as expected. Sales of these businesses are captured at our other revenue section of our P&L, and they saw over 40% growth against the prior quarter.

Sales of Storz & Bickel vaporizers increased 46% over the last quarter, due to solid organic growth, as well as seasonal sales over the Christmas holiday season. And we estimate the seasonal timing benefit added around CAD 5 million of incremental revenue during the quarter. This Works revenue increased 42% on solid organic growth, and our latest acquisition, BioSteel, also contributed a full quarter of revenue.

We are pleased with the performance of our strategic acquisitions and point out that Storz & Bickel, This Works, and BioSteel accounted for nearly 22% of our revenue in the quarter. Looking forward to the fourth quarter, taking into consideration some timing benefits we saw during the third quarter, we anticipate our overall revenue to be up modestly versus the third quarter.

I would now like to take a few moments to provide Canopy's perspective on a dynamic that we are seeing in the Canadian rec channel. Over the past number of weeks we've seen examples of aggressive pricing by some competitors which began in earnest in the back half of the third quarter, and we expect these isolated pricing actions to continue, as our market intelligence suggests that these competitors are focused on freeing up cash from their long inventory positions. At the same time, we see strong consumer demand for premium, high-THC strain products, as evidenced by the well over 50% growth we saw in our LBS Sunset premium flower and pre-rolled joints during the quarter.

We believe our brand architecture is working as we focus on building brand equity, while offering consumers a range of products across premium, mainstream and value price points. And we will continue to monitor the market and adjust as needed to remain competitive, but TWD will continue to serve as our price fighter in the value segment.

Now, let me briefly cover gross margin. Gross margin in the third quarter of fiscal 2020 before IFRS fair value impacts, was CAD 42 million, or 34% of net revenue. Gross margin in the quarter benefited from higher capacity utilization, which is a trend that we've seen over the past few quarters. Operating costs related to underutilized facilities has continued to decrease from approximately CAD 24 million in the fourth quarter of fiscal 2019 to under CAD 8 million in the third quarter of fiscal 2020.

The growth of our higher margin consumer product businesses, such as S&B and This Works, also had a positive impact to gross margin during the quarter. We remain committed to delivering 40% gross margins in the short term, as we expect ongoing reductions in various period costs. But we recognize that there are delays in our beverage and vape products will serve as a modest headwind in the short term, and it's also worth while highlighting that any right-sizing on our supply could introduce some short term headwinds as well.

Speaking briefly about operating expenses, total OpEx declined 14% versus the prior quarter and G&A declined by over CAD 20 million versus last quarter as a couple of the discrete expenses were not repeated in the third quarter, as well as the focus on continued cost controls in this area. Share-based compensation expenses decreased from CAD 92.9 million in the second quarter to CAD 61.7 million in the third quarter, and the decline in stock-based compensation was due to certain onetime benefits as well as reductions that resulted from the restructuring of our share-based compensation program that I spoke about last quarter.

Looking forward to fiscal 2021, and with the restructurings that we made, we expect share based compensation to be 30% to 40% lower than in fiscal 2020. Further, we expect share-based compensation to normalize over time at between CAD 125 million and CAD 150 million per year depending on head count. I highlight that we provide a full discussion of our operating expenses in our MD&A, so in the interest of brevity we are eliminating a comprehensive discussion of operating expenses from our press release and from this conference call, and you can expect this to be our standard practice in the future.

Moving on to free cash flow. Our free cash flow in the third quarter of fiscal 2020 was an outflow of CAD 360 million, which is a 16% improvement over the second quarter of fiscal 2020. And as David highlighted in his remarks earlier, a key priority is to reduce cash burn. And I am confident that the work that we started in January, will identify opportunities to reduce operating expenses and will moderate our capital expenditures, as we seek to focus our efforts and align our organization to our key priorities.

Another key focus area is better managing supply and to work towards having a supply and demand balance as quickly as possible. During the third quarter, our inventory before fair market value adjustments increased CAD 81 million versus the last quarter. Acquisitions and our US hemp harvest contributed around CAD 20 million of this increase, but the balance was driven by an increase in our semi-finished goods, such as resins, distillates and isolates.

As David indicated in his prepared remarks, we have initiated a thorough review of our production footprint, and we plan to act quickly to right-size our supply to align with the current market demand, while ensuring that we can deliver on our margin commitments. Next, I would like to provide a brief update on our transition to US GAAP. Our preliminary view of the change in accounting principles has identified a number of changes to the consolidated statement of operations, and I will highlight a few of them now.

First, under US GAAP, there is no biological asset accounting. Under US GAAP, agricultural products are accounted for at cost. And this change will have no impact on our adjusted EBITDA metric. Second, under US GAAP, the amortization of right-of-use assets is no longer considered as a component of depreciation and amortization expense, and as such, is not excluded from adjusted EBITDA going forward and this will have an impact of reducing our adjusted EBITDA by an estimated CAD 10 million on an annualized basis.

The third item to be aware of is in our accounting for other financial assets and financial liabilities, there will be changes in the classification of certain other financial assets and liabilities, which will result in fair value adjustments impacting net income, and this is in lieu of reporting against OCI or other comprehensive income. And as these fair value adjustments are currently excluded from adjusted EBITDA, there will be no impact as a result of the change to US GAAP.

Finally, I would like to provide just a brief update on some of the priorities I covered during our last call. We are making tremendous progress in reengineering our financial close and reporting processes, and we expect to achieve the accelerated close timelines required at our fiscal year end. We continue to make progress in improving our control environment, and we've begun testing the effectiveness of end user computing controls, and we are on track to remediate the currently reported material weakness by the end of the fiscal year. We've also made solid progress in the design of our SAP, ERP solution, which will eventually roll out across the entire enterprise and we are on track to roll out the SAP solution in the United States beginning in the first quarter of fiscal 2021.

This now concludes my review of Canopy Growth's financials for the third quarter fiscal 2020 ended December 31, 2019, and we are happy to take questions from analysts at this time.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Chris Carey of Bank of America.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Hi. Good morning.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Good morning.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

First of all, David, congratulations on your new role. And I guess, like, clearly a number of line items were quite a bit ahead of expectations on revenue and profit, right, but I think as you implied in the prepared remarks, the one area which still underwhelm was free cash flow, which is really where I think the debate around the cannabis story is focused now. And it sounds like we're going to get more details around that in fiscal Q4, so perhaps I'll approach this question a little differently.

You mentioned that managing inventory relative to demand was a key focus and you're reviewing your footprint, clearly that could imply shutting down some production capacity. And I just wonder, from a practical standpoint how difficult is that kind of endeavor and what could that mean to near-term margins even if positive for the long-term.

And I guess connected to that is, Mike, you had mentioned that you'll expect to get the 40% gross margin over time. Potentially, that's a mixed comment on the fiscal Q4, but does that imply that the 40% is more kind of a fiscal 2021 reality? Anyway, so thanks for all those.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

Yeah. Sure. So, yeah, Chris, so, first of all, we are not going to run out of cash. And we have a lot of levers to pull in that regard and as I indicated, we'll talk about that more on the next call. Clearly, we have to do a better job managing inventory and overall working capital. We have to slow our CapEx spend. We will pull back on the M&A activity that the business has been doing and we need to do a better job with our P&L. So, literally, we need to work across every line item.

We're going through a review process. I've been in the role, actually, it's one month today. And I will say that the team is a fairly – a very strong team at the leadership level at Canopy and the team is very committed to the objectives that I talked about, my priorities that I talked about in my script.

So, I'll let Mike comment on the timing of margin achievement, but we will do the right thing for our stakeholders which means our shareholders, our consumers, and our employees, and we'll communicate that as soon as we can and then when we do, there'll be an obvious flow through that will have to be taken into account.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Yeah. And I just – I would just add to that, that whatever we do, we want to do it with an eye toward not just what works for today, but what works for the long-term as well. And as you guys have heard me talk about over the last year, starting up and shutting down facilities is really hard. So, we need to be very thoughtful about it, very mindful about it and we're taking a strategic approach to say, look, we want to make sure that we're designing our supply chain and our footprint for not just the realities of today, but the realities of the next year, two years, three years as the size of the market develops, but also as the various categories of the market develops.

And we know that the value category is here to stay. We're quite happy with how TWD is performing in the market and we want to make sure that regardless of what consumers are buying, that we've got line of sight to deliver our target margin profile across the entire range of products that we offer to our consumers. So that's the work that's underway. And really to engineer the ideal supply chain that allows us to achieve those financial objectives.

So on the short line, are we going to face some headwinds with some of the cannabis delays? Yes. Are we going to face some headwinds from some potential deleveraging of facilities in the short run as we make some fine-tune adjustments? Yes. Is that going to move us materially off of our 40% gross margin goal? I do not think it will.

Operator: Your next question comes from the line of Glenn Mattson of Ladenburg Thalmann.

Glenn G. Mattson
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Hi. Yeah. Thanks for taking the question. David, you made very specific comments about the US market opportunity. I believe you said that you see a need to move faster in the US creating brands specifically, and getting distribution to customers who can buy them. So I'm curious what you meant by that a little bit.

And number one is do you see yourselves having to make a significant further investment in the US? And then number two, when you mentioned customers who can buy them, are you talking about THC-based products to customers in the US? And maybe just flesh out those comments a little further. Thank you.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

Yeah. So, we know where we sit today, it's really focused on hemp-derived CBD and there are states where we're free to sell our products and other states where we're not so that was really the point of that comment and I don't see significant investments. Clearly, no incremental capital required in the US. It's really more about getting our brands on the shelf at retail as much as we possibly can across the US.

We launched First & Free in December. It was mostly an ecommerce launch. We now need to get on the shelf with First & Free and with some of our other products such as BioSteel with CBD in the US. So it really is more about execution and quite frankly, Glenn, I think that's the point that I can make about Canopy in general, I think we're well positioned in terms of product development and production capacity, we now need to begin to really connect with that consumer and execute from a sales standpoint and a brand building standpoint so that we can create that – those trusted brands in the minds of the consumer. That's the next stage of our evolution and clearly we'll be focused on that in the US.

Operator: Your next question comes from the line of Vivien Azer of Cowen and Company.

Vivien Azer
Analyst, Cowen and Company, LLC

Q

Hi. Good morning, and congrats, David, on the new role. Thank you very much for the prepared remarks. I was hoping to get some perspective, strategically, David, from you on kind of the balance of priorities between top line growth and profitability.

It seems from your commentary that, clearly, there's a laser focus on right-sizing the business from both you and Mike, which I think is encouraging. But you did make a point of reinforcing your market share leadership in the category. And so, I'm just trying to understand, how committed are you to market share leadership? Are you willing to sacrifice that to attain your profit aspirations? Because given your background you certainly I think would be comfortable not being a market leader but operating from a position of market share gains once you've achieved the right profitability framework. So any commentary on that would be helpful. Thanks.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

Yeah. Viv, so look, that's why we haven't raised to put out cut numbers for staff, what you're seeing across the industry, because I think it's important to understand where we need to win, and where we want to win, and where we can profitably play in the business, and then we'll continue to invest in those areas, and we'll pull back spend from the areas that don't fit into that category.

I think the thing that we do have to keep in mind though is that we are in a growth industry. And I know there's a bit of a pall over the industry of late, but we need to keep in mind that this is a growth industry, we're still attracting new consumers to the space. We see ways for us to be profitable across the spectrum as – of consumer preference as Mike talked about, our ability to be profitable at the value end, as well as our ability to be profitable at the premium end and we just need to get our business focused on executing in those areas. I think there is a school of thought though, that we can continue to drive industry share leadership and improve profitability at the same time by simply creating a tighter focus on the consumer proposition.

Operator: Your next question comes from the line of Adam Buckham of Scotiabank.

Adam Buckham
Analyst, Scotia Capital, Inc.

Q

Hey, good morning. Thanks for taking my question. So I was just hoping we could get a little more color on the B2B segment. So, just want to get an idea whether there is any bulk sales in the quarter, and if there was, what the magnitude of those were versus previous quarters? Thanks.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Yeah. Thanks, Adam. We did have some bulk sales in the prior quarter. This quarter it was non-existent, to my knowledge, continues to be an area of consideration as we think about right-sizing our inventories across certain segments of the value tier, but at this point, we're focused on getting our product to market, not necessarily pursuing wholesale, but that's an option that continues to exist.

Adam Buckham
Analyst, Scotia Capital, Inc.

Q

Yeah. Great. Thanks.

Operator: Your next question comes from Andrew Carter of Stifel.

W. Andrew Carter
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hi. Good morning. I just want to return to kind of the comment around the modest revenue growth quarter-over-quarter and just kind of help us understand what that means for the rec business? You called out the CAD 5 million of seasonality, suggesting a [ph] CAD 119 (00:34:48) base. But how should we be thinking about Canadian recreational business? I would assume that the business is now kind of aligned where shipments will better match kind of the consumption growth with the market. Should we be factoring in a lot of price compression? You obviously will have some second wave shipments. Just help us understand, how you're thinking about that line item?

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Sure, Andrew. We are not modeling in anything for price compression at this point. We are modeling in that the mix in the category continues to evolve as TWD establishes itself in the marketplace and that brand is performing quite well. But the high-end is also performing quite well. The pre-rolls are performing quite well. My comments around a modest growth in the quarter are really driven by just, as I mentioned, that some of the seasonality benefits from S&B and even our retail stores in Canada benefited from a very strong December, so there's a bit of a headwind going into the next quarter as a result of that. And store count continues to increase.

And you're correct, we are seeing tremendous benefits of supply chain stability. All the provinces are now getting their inventories in order, and we're starting to establish the cadence of not quite a mature industry but there's line of sight to getting to a mature industry in the near term. And quite honestly, our biggest opportunity today to grow in what's relatively a static sort of store count environment, is continuing to get the right product at the right time as the purchase orders come in from the provinces, driving our fill rate up by better forecasting and better fulfillment. So that's where our growth is going to come from in the near term and then as the stores continue to increase, we will continue to deliver.

Operator: Your next question comes from the line of John Zamparo of CIBC.

John Zamparo
Analyst, CIBC World Markets, Inc.

Q

Thanks. Good morning. I wanted to ask about the retail function at Canopy. So subsequent to the quarter you announced a meaningful increase in the total footprint in terms of the Ontario license lottery winners. So I assume it's fair to say that you've seen something about retail that's made you want to get more involved. So I'm wondering, is it as simple as unit-level economics are really attractive, or is it more the ability to sell your own brands? But just would like to get a sense of how you view retail and maybe how much capital you might allocate to that over the next couple of years? Thanks.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Yeah. Great. So yes, store count continues to increase. I think we added 15 stores in the quarter, 12 stores in the quarter from 15 to 27 between own stores and partner stores. But we were very happy with our store performance, and the economics become very attractive in our stores when Canopy share of store sales reach that 60%-plus range, which we're starting to see across our network.

But that gives us the best opportunity to build brands, to educate consumers. It allows us to do pop up activities to help educate consumers on different formats and things like that. And then as Cannabis 2.0 rolls out, it's going to be an incredibly valuable format for introducing new consumers to these new products as well. So we expect to continue to add stores in a very strategic way. Ontario is our biggest opportunity in front of us and we had a press release about that a few weeks ago that I'm sure you saw. So it continues to be a priority for us.

Operator: Your next question comes from the line of Michael Lavery of Piper Sandler.

Michael S. Lavery
Analyst, Piper Sandler Companies

Q

Thank you. Good morning. You touched on a couple of the drivers of the inventory build and obviously some of the 2.0 launch and building into that is a part of it as well. Can you just give us a sense of how it's likely to evolve from here? And was this last quarter the peak inventory levels or is there any reason it might actually still go higher? How do we – how do you see that working down and at what kind of speed?

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

I'll let maybe Mike comment on some of the details, but my early observations, Michael, are that we're, as a company, we built inventory but we need to get better at connecting the consumer demand signal to the inventory that we're building so that we can deliver that high end consumer experience that is expected of leaders in the space. And I think we're in the early innings of brand building in cannabis and so we need to be on the shelf with the high THC bud that the consumer is demanding at the right price points. And so for us, we're going to continue to make sure that we're not stocking out at retail, which is not good for us, it's not good for brand building, it's not good for our retail partners. At the same time, we need to be able to bring down our total inventory balance. And that, as I said, is the work that's going on as we look at our footprint because we need to be able to both decrease our inventory, make sure we stay on the shelf at retail, and deliver the quality experience that we feel should be expected of our brands.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

I think that's very comprehensive. I would just add, Michael, that I would not model that this is our peak quarter. I think as we do the strategic review, there's a lead time to any decisions that we make. That being said, I would not say that the increase is going to be material in Q4. I just don't think we can call it a peak at this point until we finish the strategic review of our footprint.

But directionally, we know that we can do a better job of managing inventory relative to overall sales and everyone knows the story of anticipated market growth and where we are, so we're working through that as we speak.

Michael S. Lavery
Analyst, Piper Sandler Companies

Q

Okay, that's helpful. Thank you.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

You're welcome.

Operator: Your next question comes from the line of Aaron Grey of Alliance Global Partners.

Aaron Grey
Analyst, Alliance Global Partners

Q

Hi, thanks for the question. I just want to dive back a little bit into the market share trends. So, I believe you said 22% for the rec market in the quarter. I think last quarter was just north of 25%. So, could you talk a little bit about the market share trends you saw during the quarter? Would it be fair to think that as the quarter went on, you saw the market shares fall as you saw that aggressive pricing from competitors?

And then as we see this aggressive pricing of competitors and potential shakeout, is it fair to think that we continue to see some at least near-term share being lost with the aim of long-term share gains as you've kind of made it clear that you're not going to come and play in those super low-priced categories with the aim of coming out more premium products and just having TWD. So, how should we think about near-term shares and kind of that long-term share aspirations? Thank you.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

I'll take this one. So, yes, we did see some modest share declines as you referenced. But I would also point out that there's been some variability in that as the industries develop. What I commented on earlier around some of the isolated pricing actions, we've made a decision to not chase those price points in some instances. So, there has been some share impact as a result of that. However, our goal continues to be achieving between a 25% and 30% market share, there's going to be a little bit of noise with some of these isolated pricing actions that we think will go away over the next several months. But 25% to 30% is really our goal and we think we're well-positioned to achieve that. But yeah, you might see some noise in the numbers between now and call it the longer term.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

And what I might do, Aaron, is also almost come back to Vivien's question and say, we like to split in the market with maybe 40% is more premium of the total market, I'm saying, 30% is at value, we won't chase market share at any cost. But I think the best thing we can do to continue to drive market share for us is to make sure that for our premium products that we are on the shelf consistently at retail. I think that, more than anything else, can move the needle for us in terms of share – holding share or growing share in the near term.

Operator: Your next question comes from the line of Rupesh Parikh of Oppenheimer.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my questions. So I wanted to go back to your other businesses and the acceleration that you saw there. So outside of – I know there's a seasonal benefit that you saw, but if you look at the Storz & Bickel vaporizer business and This Works, just want to get a sense of in terms of what's driving the strength of both businesses and just how to think about them going forward outside of that seasonal benefit.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Yeah. We had a – it's a few things. There's been a number of new items that we've previously press released. So, innovation is driving a good portion of the growth. We have a new distribution agreement with Greenlane in the US, so we're seeing some good growth there as well. And we've built a good business, as you guys know, this is a fantastic brand. And as we talked about the brand building and being more consumer aware, I think David and I are of the opinion as many of our management team is, S&B is an amazing brand that we could leverage for so much more than what we are today. So we're working on future plans to further exploit that brand globally. But a lot of innovation coming next year as well, so, yeah, we did have some seasonal benefits, but that being said, we still see that as a growth business over the next year or two.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Anything there...

Operator: Your next question comes from Graeme Kreindler of Eight Capital.

Graeme Kreindler
Analyst, Eight Capital

Q

Yeah. Hi. Good morning. Thank you for taking my question. I wanted to follow up, Michael, in the prepared remarks, you mentioned that there was higher capacity utilization in the quarter. When I look at the kilograms harvested figure, if my numbers are correct, it was around 29,000 kilograms this quarter, and in the previous quarter, it was 40,000 kilograms.

So that number coming down, just want to square that away with the higher capacity utilization. And also, tying that back to talking about right-sizing the footprint, whether we're already seeing some evidence of that, given where the harvested number is going quarter-over-quarter. Thank you.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Sure. Two things I would point out. Number one, given our large greenhouse footprint, yields vary throughout the year based on the season. And yields, certainly, are lower in the October, November, December timeframe, which we model in and take that into account in all of our standard costing.

During December, we did take down some capacity at our Delta facility in British Columbia, it's one of our first steps to help bring supply and demand into balance. There are some fixed costs deleveraging impacts of that to the tune of around CAD 850,000 a quarter, but we also believe that in concentrating our efforts at Delta, we actually get benefits with the remaining facility in helping to improve yields there as well, so a very balanced approach.

But when we think about broad utilization across our network, our overall network despite the fact that yields ebb and flow throughout the year, the actual number of square feet in our facilities are operating more in line with their goal with the retrofit activity being largely complete.

Operator: Your next question comes from the line of Owen Bennett of Jefferies.

Owen Bennett
Analyst, Jefferies LLC

Q

Good morning, guys. And more a modeling question for me. And obviously, because you have a revenue line accelerating quite strongly, which you expect to continue. I was just wondering, could you give any insight into gross margins and in the overall revenue and businesses and even potentially kind of international medical business and to kind of help with how we see that sort of gross margin progressing throughout the year and what support it will get? Thank you.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Yeah. So Owen, my recommendation would be that we talk to you offline about that versus going into a lot of details. But the S&B, First & Free C3 businesses have all been performing at that 40% plus margin, and in some cases C3 is materially above that, it's our pharma grade cannabinoid based business. In terms of guidance on that from a modeling perspective, I think modeling S&B and First & Free in that 45% range is a good estimate, and C3 has been in the 65% to 75% range, and we expect those two to hold over the short-term.

Operator: Your next question comes from the line of Matt Bottomley of Canaccord.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Yeah. Thanks. Just wondering if you could provide any color on the assumptions going into I think it was about a CAD 5 million price provision or sales allowance provision this quarter for related to this particular SKUs or any other assumptions. And then also, if I could just sneak in there, if there's any color on the proportion of your inventory balance at period and how much of that relates to things like dry bud versus product in the pipeline to be launched in Cannabis 2.0? Thanks.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

Sure. So, yeah, we booked about CAD 5 million in the quarter as a revenue provision. And I think just – going forward, as we think about revenue provision, it's a cost of doing business and every CPG company I've ever worked at has always had an ongoing provision. And it's really a function of what are your customer agreements. In this industry, our customer agreements in Canada are very favorable to the customer, meaning they can return anything at any point in time, which is a more, I'd say, liberal approach than what I've seen elsewhere, and hence we take a slightly more cautious approach in booking revenue provisions.

As I think about modeling going forward, 3% to 4% of revenue is a very reasonable number given the risk profile, the amount of inventory that we see at the province level, and I would expect that to be kind of the normal range going forward. But we true it up every quarter. We look at what's actually come back, and it's meant to cover not just returns but also any provisions for any potential markdowns, or we call them buy downs, at the province level. Just for the inventory that's within their four walls. This is not meant to be a provision for what exists in retail, it's meant to be just a provision for what exists at the wholesale level.

So as the wholesale inventories come down to that CAD 4 million to CAD 6 million range, there's just not much risk out there. So the CAD 5 million – in terms of unpacking that for you, CAD 1 million of that, CAD 1.5 million I think it was for potential returns on just random products across the supply chain, where provinces are long on certain SKUs, it's very immaterial and the balance was a provision for potential pricing impacts on certain SKUs in certain markets where we're not quite aligned to our national pricing architecture and we wanted to provide that allowance so that we could get things lined up properly. But it's, in the grand scheme of things, it's 4% of revenue, and that's just going to be our normal course going forward. So I would build that in.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Thank you.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

In terms of inventory, Owen (sic) [Matt], I think your part two, the question was on inventory so I apologize, but on inventory, yes, so our inventory – we think about our inventory really in a few buckets. Number one is how much of our inventory is distillates and isolates and whatnot and a lot of the inventory that we're showing there is the anticipation of Cannabis 2.0.

And jury is still out on how big each of these categories are going to be, but we are well positioned on the distillate and isolate to fuel whichever category of Cannabis 2.0 SKUs really take off, and the shelf life on the isolate is very high, so we don't have any concerns around quality of that inventory relative to the shelf life.

The balance of the inventory is really our bud inventory and we feel very good that we're balanced on high-THC bud, we feel very good that we're balanced on low-THC, high CBD bud, the mainstream bud, which is the balanced, is what we call it, we're a little longer than what we'd like to be today. And that's the piece that we're continuing to work through.

Operator: Your next question comes from the line of Jason Zandberg of PI Financial.

Jason Zandberg
Analyst, PI Financial Corp.

Q

Hi, thanks for taking my question. Just first of all wanted to applaud the reduction in operating expenses this quarter, especially in the G&A. One line item there that I think is positive, it's increasing, is the R&D line. But I want to sort of dig into that just for sort of future modeling purposes. You described the increase and were kind of in the mid-teens in terms of a percentage of revenue. You know, talk about some clinical trials of CBD-based studies as well as some product testing for Cannabis 2.0. So is this a sort of one-time bulge in – not one-time but sort of, over the next couple quarters of bulge in R&D, or should we expect this line item to increase, sort of what's your long term goal as a percentage of your revenue?

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

So, Jason, when – R&D is an area that I've already spent some time on since I've been in the role. I think as we look at focusing the business, we have to decide where we're going to invest from an R&D and innovation standpoint. And by the way, there's a bunch of stuff in that line item, it's not pure R&D. Some of it is engineering activity, some of it is even manufacturing engineering, right, so there's a lot of noise in that line. But when we get on the call in the fourth quarter, and we're providing more clarity on specificity of that focus that I want to bring to the business, we'll make sure that we address the R&D line in detail.

Operator: Your next question comes from the line of Pablo Zuanic of Cantor Fitzgerald.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Thank you and congratulations, David, on your appointment and on the good quarter. Look, just one question, it's a bit of an industry question. I think you said that value for you was 30% of the portfolio, I'm hearing from other people it's close to 50% of the industry. If that's what we're seeing in the flower market, does that say something about the Canadian consumer in cannabis being very thrifty? And does that bode badly for the 2.0 category as a whole given that the price points are much higher? If you can comment on that. And then just, if I can sneak in a quick follow-up, it'd be nice if you can clarify of the other line, what percentage of that revenue is outside North America? Thanks.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

So I'll let Mike handle the revenue – the other revenue, but yeah, Pablo, so I think the thing that's interesting to me is, we have an existing consumer today that's been pulled largely from the illicit market and if that consumer today is, if, say, 40% of the spend is happening in the premium segment in the market, so I'm kind of flipping your question around a little bit, we feel pretty good about that because I think that looks like a lot of other CPG categories.

It's my belief that as we bring 2.0 consumers in, they're likely to come in at the higher end of the category because they're going to want, as well as premium bud, they're going to want experiences in other product categories, like vapes and edibles, drinks, gel caps, we just see them coming in differently.

Now, what I'll say though is that I believe that that's probably a longer build. So, it'll take a while for that market to evolve. I keep talking about, there are a lot of consumers that we – in the market today and we need to delight those consumers, but there are also a lot more consumers that don't even know that they love cannabis, but they will learn that over time and I think those folks will come in at higher price points and at the premium end of the category.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Thanks. And the other revenue -

Operator: Your next question comes from the line of Endri Leno of National Bank.

Endri Leno
Analyst, National Bank Financial, Inc.

Q

Hi, good morning, and thanks for taking my questions. Just wanted to go back quickly on the Cannabis 2.0 and particularly on the beverages. First, but just if you are able to clarify what caused the initial delay and where are you now resolving the cause of that delay? And then more on the overall 2.0 portfolio, like how do you see developing vis-à-vis the dry bud only that you have right now? And how much could it contribute towards, say, your previous guidance of CAD 250 million revenue per quarter? Thanks.

Mike Lee
Chief Financial Officer, Canopy Growth Corp.

A

So, [ph] Chris (00:58:22), if you don't mind, I want to take Pablo's question because he got cut off there, but we will follow-up, Tyler can follow-up, Judy can follow-up with you, but international revenue today, defined as revenue outside Canada, is around 35% of total revenue. And Judy or Tyler will follow-up with you after the call to make sure you get your questions answered.

And with that, I'll turn it over to David, he can answer that beverage question.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

Yes, so look on beverages, whenever you launch a beverage whether it's alcoholic drinks, non-alcoholic drinks, and clearly cannabis drinks, it takes a while to get your formulations exactly as you want them, you need to ensure that you're having appropriate stability, that we want the product to look appropriate when it's on the shelf. And we had time to do this work at lab scale leading up to obtaining licenses on – from Health Canada on 2.0. But kind of post obtaining those licenses, we've only had a very short window of opportunity to go from lab scale production to commercial scale production. And we've had some issues as we've made that jump. And also understand that it's a very involved quality process that we're putting ourselves through, because we believe these are spectacular products. We want to make sure that when the consumer tries them that they decide that this is their thing, right?

So we want to get it right. We're taking maybe more precautions than would otherwise happen in terms of working our way through that quality process. We have some outstanding scientific and engineering and innovation talent working on our 2.0 launches. And as I said, it's just taking longer than we would like, but we think it's worth getting the products right, as opposed to just rushing them out there to make an in market date.

Operator: Your next question comes from the line of Chris Blake of Laurentian Bank.

Chris Blake
Analyst, Laurentian Bank Securities, Inc.

Q

My questions have been answered. Thanks very much.

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

Okay.

Operator: Your final question comes from the line of John Chu of Desjardins Capital Markets.

John Chu
Analyst, Desjardins Securities, Inc.

Q

Hi. Just quickly, so with the aggressive US expansion on the product launches, you've got edible launches coming up now and then it looks like you're going to be potentially adding quite a few more new retail stores, especially in Ontario. From a sales and marketing perspective, should we see that jump up for the next several quarters at least, while you're trying to position the products and the launches accordingly?

David Eric Klein
Chief Executive Officer & Director, Canopy Growth Corp.

A

No. Again, we're still doing the work, John, in preparing for kind of the next phase, actually, even working on next year's plan. So I don't have a definitive answer, but you won't see the number jump up.

Operator: Those are all questions at this time. This concludes today's conference. You may disconnect at this time.