Corrected Transcript

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Aphria, Inc. (APHA.CA)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Kensey, and I will be your conference operator today. At this time, I would like to welcome everyone to the Aphria Inc. Q3 Quarterly Investor Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session for analysts and/or investor firms only. [Operator Instructions] Thank you.

Ms. Katie Turner, you may begin your conference.

Katie Turner
Partner, ICR LLC

Thank you, Kensey. Good morning, everyone. We appreciate you joining us to discuss Aphria Inc.'s financial results for the third quarter ended February 29, 2020.

On today's call are Irwin Simon and Carl Merton. By now, everyone should have access to the earnings release, the financial statements, MD&A, and investor presentation, which are available on the Investors section of Aphria's website at www.aphriainc.com. The financial statements have been filed with SEDAR and EDGAR.

Before we begin, please remember that during the course of this call, management may make forward-looking statements. These statements are based on management's current expectations and beliefs, and involve known and unknown risks and uncertainties which may prove to be incorrect and actual results could differ materially from those described in these forward-looking statements. Please note that text of Aphria's earnings release and the financial filings issued yesterday are a discussion of the risks and uncertainties associated with such forward-looking statements.

I'd also like to note that we're conducting our call today from our respective remote locations. As such, there may be brief delays, cross-talks, or other minor technical difficulties during this call. And we thank you in advance for your patience and understanding.

And now, I'd like to turn the call over to Irwin.

Irwin David Simon

Chairman & Chief Executive Officer, Aphria, Inc.

Thank you so much, Katie, and good morning, everyone. We appreciate you joining us today to discuss our strong third quarter financial results. Before I get into our robust sales growth, brand strength, profit improvements and strong balance sheets and cash flow, I'd like to comment on COVID-19 global health crisis, and what we are experiencing across our operations in the industry.

First and foremost, our thoughts, our prayers go to all those affected by this virus, and that includes plenty of people. As the situation has continued to rapidly evolve, our number one priority has been ensuring the health and safety of our employees and their families. Our leadership had a plan in place ahead of this, and I'm proud to say we took decisive action and executed well.

We're fortunate that all our facilities have been deemed essential by their respective governments. This is a privilege and a responsibility we do not take lightly. It's a privilege to continue to be fully operational across our Canadian and International operations, as we serve our valued patients and consumers, providing with our medical adult-use cannabis products. We remain committed to providing best-in-class products and services during this time and need, and uncertainty as a result of COVID-19. And we will continue to work with local, provincial and federal regulators to help eliminate the illicit market.

At the same time, we have a tremendous responsibility at Aphria to our employees, their families, and the communities we operate in. We took decisive action and implemented heightened safety measures in our facilities to protect us against and prevent the spread of COVID-19. These include, but are not limited to, staggering work schedules, redesigning work facilities to ensure appropriate social distancing and significantly enhancing sanitation and regular cleaning procedures.

We are immensely grateful to our employees that work in our production facilities and had proactively taken action to reinforce our appreciation and our commitment to them. At Aphria One, we have accelerated and implemented a planned wage increase for all hourly employees and implemented a company paid lunch program for all employees. We're also very pleased to have not had any layoffs and the vast majority of our operational employees continue to report to work each day to maintain production and shipping schedules. In fact, we are even hiring for certain operational roles.

Our teams continue to work closely with our global supply chain partners to prevent and minimize any potential business disruptions. In Canada, we took preemptive measures to ensure alternate supply sources if needed. Like many consumer packaged goods companies, Aphria also experienced, prior to the lockdown, consumer demand at the beginning in place that the – of the government mandates.

More recently, consumption has returned to a more normalized pre-COVID-19 levels for all regions, except Québec, where cannabis sales remain at even a higher level. Our Canadian medical cannabis has experienced increase in demand since the outbreak of the virus.

In Germany, as many of you know, CC Pharma is an important distributor of pharmaceutical products; and as you would expect, we have seen such increase in consumer demand for our medicines. We experienced solid growth in Q3 for the month of March. CC Pharma has experienced a 15% sales increase. Our team is taking steps to secure supply and is closely monitoring the situation should any countries in the EU change their border policy as a result of COVID-19.

Our team has accomplished a lot on all fronts. And as I said before, what a difference a year makes. Last year at this time, during our earnings, it was a totally different story. At Aphria, we're setting ourselves apart from the rest of the cannabis industry. We had generated some of the strongest sales growth. We have one of the strongest balance sheet and cash position, compelling consumer brands, as well as diversified global business.

Our Q3 results demonstrate this with the hard work of our strong team. We generated a 65% increase in net sales revenue from prior quarter, our fourth consecutive quarter of positive adjusted EBITDA. Consolidated adjusted EBITDA in the quarter more than tripled to CAD 5.7 million from the prior quarter. Most notably, adjusted EBITDA from cannabis operations increased 78% and adjusted EBITDA loss from business under development decreased by 20% in the quarter.

In an industry call it cash burns, we're pleased with our ability to generate consistent results. During the month of January, we also raised approximately CAD 100 million in capital to further build and strengthen our balance sheet. We continued to possess an industry-enviable balance sheet and cash equivalents to fund planned Canadian and International growth. As they say, cash is king.

A cornerstone of our long-term strategy is to be focused on the highest returns that prioritize growth. Our growth has enabled us to be one of the only profitable publicly-traded license producers in the industry. We believe we have the appropriate capital structure for our business and this provides us with strong financial flexibility well into the future. This continues to further differentiate Aphria in the cannabis industry.

In Q3, we demonstrated our ability to continue to be a leading producer with both Aphria One and Aphria Diamond fully licensed and operating at 100%. Aphria Diamond is already in its second crop. I want to thank the Mastronardi brothers, our partner here, for all their help to make sure this happened.

In Leamington, we are consistently working to generate greater yields at lower cost. We're pleased that in Q3, cash cost per gram decreased to below CAD 1. We're excited about the tremendous growth opportunities we now have, as a result of expanding our total annual domestic production capacity in Canada, as well as our strong medical and adult-use brand sales extraction capabilities, and our ability to export EU GMP products and white label opportunities.

From enhancing our global team, our brand-building activities, new facility and production capabilities to investing in new systems and technology, Aphria is well-positioned for future growth. We have compelling brands for patients and consumers across broad demographics with five high-quality brands including Solei, RIFF, Good Supply, Broken Coast and, of course, our Aphria Medical brand.

We are increasingly connecting with consumers through our medical and adult-use brand positioning and innovation to drive growth. We added 100 basis points to our market share in Ontario during Q3. We added 400 basis points to our share in Alberta. Aphria maintains a 77% share across all brands on vapes in Ontario.

We increased our national share in each of our last four quarters. We continue to make progress in Ontario. For the month of March, Aphria had number three – had three of the top five brands. Good Supply was number one, Solei was number two, and RIFF four, according to OCS. Aphria's success will be – will continue to be driven by our differentiating portfolio of brands, products, aimed at delighting the state consumer segments. We look forward to launching our edibles, beverage and topicals in the near future.

We believe the quality of our brands remain unmatched in the industry. We have a strong foundation in Canada where we expect momentum to accelerate. The strong foundation also helps us to leverage e-learnings and implement them on market-specific basis in Germany, Latin America including Colombia, Argentina, Paraguay, as well as other international markets.

Before I turn the call over to Carl, I want to highlight yet another way Aphria is doing its part to support local communities, seniors, healthcare workers during this health crisis. We're very pleased to have a major donation to the Erie Shores Community Hospital. This will help them acquire additional healthcare equipment and resources. We've also implemented a program where employee volunteers in Leamington purchase and deliver groceries and other necessity to seniors and healthcare workers during this difficult time. It is great and important for us to get back. We're thrilled to have made contributions to the communities and the people that support Aphria. Our core value of supporting the communities to which we belong, especially in these uncertain times, serves as a driving force behind our strategic decisions and outlook.

In summary, our mission is clear to be the premier global consumer packaged good cannabis company with our medical and adult-use cannabis brands. We are building brands that we believe resonate with consumers today and well into the future. Consumer behavior has already – is changing, but this change has been accelerated. Through our data insight and understanding of the consumer's preference, we believe we are well-positioned to capitalize on these changes in the cannabis marketplace.

I would like to thank and a huge thanks to my leadership team, the board of directors and our associates around the world for all their efforts in achieving sustainable results and their tireless work to continue that has kept Aphria moving forward. I'm proud of the entire team's ability to remain focused while navigating through this unprecedented time and take decisive action to adapt to our businesses while protecting our employees' health.

With that, I would like to turn the call now over to Carl.

Carl A. Merton

Chief Financial Officer, Aphria, Inc.

Thank you, Irwin, and good morning. Please note all financial references are in Canadian dollars unless I mention otherwise. Also, some of the financial metrics discussed on this call are non-IFRS measures. And I refer listeners to the company's MD&A for an explanation as to how the company calculates those metrics.

I wanted to start by highlighting three key items from our results. These quarterly results do not include any impairments, inventory write-downs or provisions for future sales returns. As Irwin discussed, we continue to execute on our growth initiatives and prioritize profitability with long-term growth and success in mind, especially now that we are in the wake of a macroeconomic uncertainty as a result of the COVID-19 global pandemic.

We are pleased with our financial results; particularly our cannabis revenue growth, sequential positive adjusted EBITDA, positive operating income, and our ability to maintain a strong balance sheet and cash position. The strength of the Aphria team has become even more evident as the COVID-19 health crisis continues. We are doing everything we can to continue serving our customers and executing our strategic initiatives.

Irwin provided an overview of the disciplined and well-planned actions we have taken across our business, and I also want to highlight a few additional industry data points related to COVID-19 that are important to keep [indiscernible] (00:15:18) Aphria as we move forward. These include, the Ontario, Alberta and British Columbia control boards were closed to deliveries and shipments for a week at the end of March for year-end inventory counts.

The Ontario control board temporarily cancelled two weeks of purchase orders from all licensed producers while it assesses its inventory balances, and is generally expecting lower volumes due to COVID-19. The Alberta control board's replenishments are down 40% since COVID-19. In BC, retail stores have or are voluntarily closing on COVID-19 concerns. Importantly, in BC, they are trying to convert their brick-and-mortar locations to click-and-collect.

Conversely, in Québec, e-commerce sales are up 200% since COVID-19 restrictions came into place and the sales of their brick-and-mortar locations are up 40%, further demonstrating what Irwin referenced with Aphria sales being higher in Québec compared to pre-COVID-19 restrictions. Additionally, our medical sales are up 18% since COVID-19 restrictions came into place, although we proactively decrease selling prices 10% to help patients manage current cash flow concerns.

There are many variables related to this global health crisis and we will continue to monitor them closely and react where and when needed, appropriately. From a liquidity perspective, we believe we have more than sufficient funds for at least the next 12 months. Our cash balance at the end of the quarter was CAD 515 million. We maintain undrawn line of credit facilities of just under CAD 4 million, and an account receivable balance that is largely with Crown corporations totaling almost CAD 80 million that is due within the next 60 days. Our accounts payable balance at quarter-end was CAD 137 million. We do not have any debt maturities occurring in the next 12 months. Our next maturity is in June of 2021 and it is less than CAD 1 million. We do not anticipate any issues with our debt covenants.

Further, to proactively preserve cash in this operating environment, we ceased all material new CapEx projects in mid-March and have eliminated over CAD 4 million from our anticipated sales, marketing and promotion spend in the fourth quarter. Difficult times require strong leadership, and they require communities coming together to support one another. At Aphria, our team is up for the challenge and is executing every day.

Before getting to our financial results, I would like to take a moment to discuss the supply and demand challenges we face this quarter. As we previously discussed, the receipt of Aphria Diamond's cultivation license last November occurred later than we anticipated. This delay led to a reduction in the amount and variety of finished product to meet market demands for our brands. As a result, and as we announced last quarter, we supplemented our own supply by purchasing wholesale flower for resale.

During the second and third quarters, we purchased almost CAD 30 million of dried flower on the wholesale market, of which approximately half was sold during Q3. The sale resulted in approximately CAD 20 million in net revenue, with a gross profit of over CAD 5 million. If we were able to produce the product ourselves, we believe we could have recorded an additional CAD 7.6 million of gross profit and adjusted EBITDA in the third quarter and an incremental 1,360 basis points on our adjusted cannabis margin. These figures are based on assumptions set out in the MD&A, including an all-in cost of sales of dried cannabis per gram of CAD 1.69.

At the end of the quarter, we maintained almost CAD 14 million of purchased dried flower in our inventory, all of which we anticipate selling in Q4. As discussed in our last quarterly conference call, at last quarter-end, we identified an excess amount of extraction grade THC dominant harvested cannabis and trim in inventory that we plan try to sell in the wholesale market during Q3.

We also identified that we had a shortfall in CBD oil, where we're going to look to the wholesale market for replenishment. As a result, we sold CAD 10 million of excess, lower potency, extraction grade, THC dominant harvested cannabis and trim, which the customer accepted title and control to, even though we are temporarily storing the product for the customer. We also purchased CAD 7.5 million of CBD distillate. The two transactions were with the same counterparty. We confirmed that these transactions are the only transactions we have engaged in with a third-party extractor.

In the third quarter, we harvested approximately 31,000 kilograms of cannabis. This includes a partial quarter of harvest from Aphria Diamond, extrapolating for the last two weeks of Aphria Diamond harvests and annualizing its harvest suggest that Aphria's facilities would have harvested at an annualized production rate of 175,000 kilos at the end of the quarter.

Our financial results continue to demonstrate our ability to continue to gain share. They demonstrate our continued focus on leveraging our cultivation expertise into lower cost per gram and our focus on remaining adjusted EBITDA positive.

Net revenue in Q3 increased 96% over the prior-year period and almost 20% from the prior quarter to CAD 144.4 million. This net revenue is comprised of CAD 88.3 million of distribution revenue, CAD 55.6 million of cannabis revenue, and CAD 0.6 million of insurance recoveries. Distribution revenue increased almost CAD 2 million from CAD 86.4 million in Q2, and cannabis revenue increased 65% from CAD 33.7 million. Adult-use net revenue increased 54% from the prior quarter to CAD 44.7 million.

Wholesale revenue was CAD 11 million. We do not anticipate this level of wholesale revenue occurring next quarter. The company sold 14,014 kilogram equivalents of cannabis in Q3, up 98% compared to 7,062 kilogram equivalents sold in Q2. Adult-use cannabis accounted for 8,171 kilogram equivalents and medical cannabis accounted for 1,352 kilogram equivalents.

The average gross selling price of adult-use cannabis increased to CAD 5.46 per gram in Q3 compared to CAD 5.22 per gram in Q2, primarily as a result of a shift in product mix. The average gross selling price of medical cannabis, exclusive of wholesale, decreased to CAD 6.41 per gram in Q3 compared to CAD 8.16 in Q2, primarily related to the introduction of a compassionate pricing program in the quarter.

During the quarter, our cash cost per gram decreased from CAD 1.11 last quarter to CAD 0.93, bringing our cash cost per gram back under CAD 1, as it has been in the past. Our all-in cost per gram decreased from CAD 1.98 a gram to CAD 1.69 a gram. We continue to work to lower these amounts and are pleased that the completion of Aphria Diamond – of the Aphria Diamond facility has already aided in lowering our cost per gram.

Adjusted cannabis gross profit increased to CAD 23.7 million in Q3, as a combined result of both increased sales and a reduction in costs. Adjusted cannabis gross margin was 42.7% in Q3 compared to 56.6% in Q2. The decrease was primarily due to the sale of cannabis that was purchased from other LPs and the lower margins recorded on wholesale revenues.

As I mentioned earlier in my remarks today, had we been able to sell a product cultivated at Aphria Diamond, instead of amounts purchased on the wholesale market, we believe we could have recorded an additional CAD 7.6 million of gross profit and adjusted EBITDA in the third quarter and an incremental 1,360 basis points on adjusted cannabis margin. These figures are based on assumptions set out in the MD&A including an all-in cost of sales of dried cannabis per gram of CAD 1.69.

Adjusted distribution gross profit increased slightly to CAD 11.4 million in Q3 from CAD 11 million in Q2. Adjusted distribution gross margin increased slightly to 12.9% in Q3 compared to 12.7% in Q2. SG&A costs of CAD 50.9 million in Q3 were CAD 1.7 million higher than in the prior quarter. The increase in SG&A was primarily related to a CAD 1.8 million increase in transaction costs.

During the quarter, we reclassified marketing salaries and wages from marketing and promotion costs to general and administrative costs, consistent with all other corporate salaries and wages. Operating income in the third quarter was CAD 8.7 million compared to a loss of CAD 9.6 million in the prior quarter. We are extremely pleased to have returned to operating profitability, an important milestone in our financial success. We reported net income of CAD 5.7 million or CAD 0.02 per share compared to a net loss of CAD 7.9 million or a loss per share of CAD 0.03 in Q2, and a net loss of CAD 108.2 million or CAD 0.43 per share in Q3 last year. Further, for the year-to-date, we reported net income of CAD 14.2 million or CAD 0.06 per share compared to a net loss of CAD 33.3 million in the prior year or a loss per share of CAD 0.13.

In an industry full of cash burns and heavy adjusted EBITDA losses, our focus remains on generating positive EBITDA. For the quarter, we are pleased to continue our trend and report a fourth consecutive quarter of positive adjusted EBITDA. Consolidated adjusted EBITDA in the quarter more than tripled to CAD 5.7 million from the prior quarter. This includes adjusted EBITDA from cannabis operations of CAD 6 million and adjusted EBITDA from distribution operations of CAD 2.6 million, but partially offset by an adjusted EBITDA loss from businesses under development of CAD 2.9 million, down from an adjusted EBITDA loss of CAD 3.5 million in the prior quarter.

Most notably, adjusted EBITDA from cannabis operations increased 78% and the adjusted EBITDA loss from business under development decreased by 20% in the quarter.

Moving to liquidity; as Irwin said, we continue to possess an industry-enviable balance sheet, made even stronger by our CAD 10 billion capital raise in the quarter, including a strong cash position, robust capital structure within our industry that provides flexibility during uncertain macroeconomic conditions and a cap table with minimum potential dilution.

As of February 29, 2020, the company had cash of CAD 515.1 million to fund planned Canadian and International growth and deal with any COVID-19 pandemic-related financial impacts. While all new material CapEx projects are currently on hold, we still have approximately CAD 30 million to spend on our German expansion and CAD 40 million to spend on our Colombian expansion.

Further, we anticipate another CAD 25 million to CAD 50 million may be necessary for working capital investments. These working capital needs are likely to decrease over a reasonable time period. As a result, this leaves approximately CAD 400 million plus the cash generated from future operations, all of which is available for future strategic initiatives. We believe this is more than sufficient to take advantage of any attractive distressed asset sales in Canada, US expansion, or other income statement-accretive opportunities, and protect us from any adverse effects of COVID-19.

In Q3, we increased our cash position by more than CAD 17 million. Cash inflows included net proceeds of CAD 99.7 million from our equity raise, CAD 9.7 million from the continued liquidation of our non-core investments, CAD 4.5 million from increases in CC Pharma's drawdown on its line of credit, approximately CAD 800,000 related to capital asset sales, and CAD 400,000 related to warrant exercises.

Cash outflows in the quarter included approximately CAD 54.4 million for investments in working capital, CAD 38.3 million in CapEx and a CAD 2.5 million OpEx burn, exclusive of changes in our working capital. Included in the investments in working capital, we already mentioned purchases of dried flower in the wholesale market of approximately CAD 30 million.

Turning to our outlook for fiscal 2020; absent COVID-19, we believe we would have achieved our guidance previously provided. However, the uncertainty around the global pandemic has now made it very difficult for us to accurately forecast our year-end results. This includes the risks associated with EU member states closing their borders to exports and the uncertainty with respect to cannabis purchases in the major provinces we serve, all as more fully disclosed in our MD&A.

As a result, we are suspending our previously announced guidance for revenue of CAD 575 million to CAD 625 million, and adjusted EBITDA of CAD 35 million to CAD 42 million for fiscal 2020.

I would now like to also provide further comments on what Irwin referenced on Aphria's position within the cannabis industry. At this point in the industry's history, it has become convenient to blame a combination of industry oversupply and lack of retail rollout for poor sales growth. We believe these statements are too simplistic in nature. We believe we have found and believe we can continue to find pockets of industry undersupply. They are there for the taking. The key is to be able to identify them, possess the capability to supply them and build brands, products and product line extensions around them. We believe that through our data insights and understanding of consumer preferences, we are well-positioned to continue to take advantage of the opportunities these undersupplied markets provide.

Aphria continues to be unmatched on a variety of financial metrics, including our record of consecutive quarters of positive adjusted EBITDA, focus on profitability, operational efficiency, and cannabis revenue. Our strong cash position will support our strong performance and underlying our ability to hold out through the uncertain times ahead.

In summary, at Aphria, we have the greenhouse space, cultivation expertise, extraction capacity, automation technology, differentiated brands, product innovation and raw materials to position us for success. As we gain scale, we will gain efficiencies in Canada. Those efficiencies will allow us to build out international distribution for our medical and adult-use cannabis.

We are pleased with our financial results this quarter and we continue to execute on our strategic priorities, namely a stronger, more profitable company, as we continue to provide support to our employees and the communities we operate in during these difficult times. We believe that Aphria's competitive advantages, brand strength, strong balance sheet and the resilience of our employees continue to position the company well as we navigate through these challenging times. We remain confident in our ability to create long-term shareholder value.

That concludes our formal remarks. Irwin and I are now available for your questions. Kensey, back to you for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. As we begin the Q&A session for today, I would like to advise everyone to please limit yourself to one question and one follow-up only [Operator Instructions] Our first question comes from the line of Owen Bennett with Jefferies. Please go ahead. Your line is open.

Owen Bennett
Analyst, Jefferies LLC

Q

Good morning, guys. Hope all well. And just a couple of questions, please. First of all, on the CapEx and what CapEx is actually being ceased, just a bit more color around that. And linked to that, are you still building Germany out and kind of sort of linked to that once more, anything [indiscernible] (00:35:09) shipment in Q4 into Europe, or is that kind of wait and see depending on what happens with COVID? Thank you.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Carl, you want to take that? Just in regards to CapEx, I think the big thing is this year, we have always spent CapEx in enhancing and upgrading our facilities, and just we pulled back on lot of those things, we are finished Aphria Diamond, there are some things in the processing area we'll continuously do at Aphria One.

In regards to Germany, it is just about finished and we will get that up and going. I was there a couple months ago. But we're going to always spend CapEx and is it 5% of sales each year, et cetera. But we have just stepped back and sort of say, right now, our facilities are in pretty good shape, where can we more or less invest CapEx and taking out costs and become a much more efficient. So, our greenhouses are in good shape. There's some work that we need to do on processing which we'll continuously do and we will get Germany finish which we're very, very close to do that today.

Carl, anything you want to add?

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

I'd just reiterate, Germany continues to move forward. Most of the work is done and there is a bit of a disproportionate between the works done and the cash we've paid at this point. There are some cash payments that are coming up shortly. We are very focused on being ready for the German market as soon as possible and are letting this delay impact that project. But where we have opportunities to defer CapEx and the starting of new projects, we have – we've ceased those pieces.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

And I don't think it's deferred CapEx so much. It's just looking at the return on invested capital and where we need to spend CapEx to really get efficiencies out there. And there's plenty of CapEx you can spend. But we will not spend CapEx unless it gets our hurdle of return on invested capital.

Owen Bennett
Analyst, Jefferies LLC

Q

Okay, great. Thanks a lot. Appreciate it.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Thanks, Owen.

Operator: Our next question comes from the line of Chris Carey with Bank of America. Please go ahead. Your line is open.

Christopher M. Carey
Analyst, BofA Securities, Inc.

Q

Hi. Good morning.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Good morning.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Good morning.

Christopher M. Carey
Analyst, BofA Securities, Inc.

Q

So clearly some strengths in different areas. I guess, the one part that I'm just trying to reconcile, right, is this dynamic of where EBITDA is improving sequentially, but free cash burn has deteriorated sequentially. Just doing the math, it's about the widest gap we've seen between EBITDA and free cash burn on record. And I'm just trying to understand as you look forward on working capital commitments or maybe if you could offer some insight on why this is the case this quarter and when this positive EBITDA starts to flow through, and show up on the free cash flow statement or the cash flow statement as well? And then, I've a follow-up.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Okay. So, Chris, the free cash flow decrease in the quarter is really being driven by our investments in working capital. I think it's important to remember that we had Aphria One coming online with its first harvests and we expect to see an increase in working capital again next quarter, and is part of what I said during my portion of the discussion.

As Aphria Diamond continues to ramp, there's five, six weeks of additional harvests that – we come on – that haven't reached a point where you can release them to the public, that number is going to build. It then goes into accounts receivable to control boards where your waiting is at least 60 days to collect on it. That's really what you're seeing this quarter. If you exclude the investment in working capital in the quarter, our OpEx burn was less than CAD 2.5 million.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

And on top of that, you're also seeing us, as Carl talked before, buying cannabis from other producers and building inventory which a lot – some of that has not been sold through yet. So you're not seeing the cash net return here and that's a big number that is there.

So the big thing in this, again, as we move into some of our biggest quarters. So, if you look at it, Aphria Diamond now has come on, so we had to invest in regards to grow there. We've bought, as Carl talked about, close to CAD 18 million or so outside in cannabis, so we're investing cash to ultimately to turn it into product with margins and that cash will come back in the next 30, 60, 90 days.

Christopher M. Carey
Analyst, BofA Securities, Inc.

Q

Okay, understood. And then, just as my follow-up, and you did allude to it there. I guess, just functionally, right, so – because you did produce, I believe, over 30,000 kilos in the quarter, so you're continuing to have nice harvests. And so, just functionally, was it that what you were producing was not necessarily the skew that you needed for retail listings and that's why you went out in the market to purchase product. I'm just trying to understand the gap between what was produced and what was sold and the decision to purchase wholesale. And effectively just so I can understand, how we get the cannabis gross margins back to where they were as you transition to more of the sales coming from your own product produced? Thanks so much.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Okay. So, Chris, I think it's important to remember, there's always that almost one quarter delay between when you harvest something and when you realistically have it out as a sale. Last quarter our harvests were not 31,000 kilos. And so, we identified that there were opportunities on the demand side to fill if we had more product. We didn't have it because Aphria Diamond's license was later than we had thought, and we bought that cannabis, right, just – but it was just to kind of replace that [ph] whole (00:42:21) that was going to happening in Q3 as we knew harvests were ramping for us that would be available to sell in Q4, but just weren't available in Q3.

So, it kind of goes back to that five-, six-week delay after you harvest something before that product is in a position to really go out of the door. By the time it gets dried, it gets radiated, it goes through your packaging process and it clears all the QA and QC tests including microbiology, pesticides, potency, all of the different tests that were mandated to do by Health Canada.

Christopher M. Carey
Analyst, BofA Securities, Inc.

Q

Okay. Makes sense. Thank you, both.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Thanks.

Operator: Our next question comes from the line of Andrew Carter with Stifel. Please go ahead. Your line is open.

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

Q

Yeah, thanks. Just a couple questions. Number one, on the CAD 11 million in wholesale, could you quantify by chance how much that helped kind of profitability in the quarter? And appreciate you kind of mentioning kind of that you would have achieved the guidance absent COVID-19, but which implied a pretty healthy scaling of the business in the fourth quarter. Would that be put off two quarters? I mean, what's kind of the impediment there? Is it getting really all 100% internal supply moving away from wholesale, getting a good run rate on second gen products? Thanks.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

So, Andrew, thanks for asking the question. On the wholesale product, we are in about a 10% margin on that, and that basically falls directly to the bottom line on the EBITDA side.

And I'd apologize, but I missed the second-half of the question.

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

Q

Yeah. Sorry. I'll ask it just a little bit better. I would say, in this – in kind of the fourth quarter, it implied a pretty healthy kind of EBITDA margin in the business absent COVID-19, I get that. It included couple things, included a stepwise increase in cannabis, a lot more internal production, if I heard that right, and then obviously second generation products will be much more meaningful. I mean, is that delayed two quarters? I mean, when do we really start to see the business start to scaling or is that just with so much uncertainty around COVID-19, it's really even difficult to even say that at this point?

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

I think...

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

So, I think – sorry, Carl. I'll say [indiscernible] (00:44:39). It's when you're in different rooms. But step back for a second, I think as you saw the increase in the third quarter and that will continue. When you have our six brands gaining share and continue to gain share, that's going to be a big lift upon our sales.

The other thing is, one of the biggest problems is just having products to sell, and now with Aphria Diamond coming on, we will have the ability to sell a lot more products. We have sold close to 100,000 vapes and we'll continue to sell a lot more of vape products. We don't have them yet, but we'll be rolling out our edibles, and that's going to be a big part of it.

But I think the big thing is, which is key, the consumer has really accepted our product, likes our product, and we're just having product to supply for them. Each quarter more and more stores come online, and I think the other big opportunity as we look at it is click and pick as we sell more and more products through e-commerce.

But the biggest opportunity for us is, we came out with good products, good pricing, good selection, good supply. We're taking sales away from the illicit market, and that's the key here is how we take sales away from illicit market, because today within Canada, 75% of cannabis still goes through the illicit market, and that's – ultimately there's 700, 800 stores in Canada today that's going after that illicit market, going after the online market and additional retail stores opening.

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

Q

Sounds good, guys. I'll pass it on. Thanks.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

Thanks, Andrew.

Operator: Our next question comes from the line of Aaron Grey with Alliance Global Partners. Please go ahead. Your line is open.

Aaron Grey
Analyst, Alliance Global Partners Corp.

Q

Hi, good morning and thanks for the question. I guess, first off, I just want to kind of ask about overall kind of sales price. You guys saw a nice sort of uptick during the quarter and there has been a lot of conversation in the market about more competition especially in kind of [ph] deep value (00:47:02). You guys have done certainly a real nice job of increasing your market share with your own brand. So, can you talk about some of the market dynamics there? What you're seeing in terms of pricing pressure and how you feel like that should evolve over the next couple quarters especially as your 2.0 products continue to rollout?

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

I'll take some of it and Carl will take the other part of it. Number one, our sales team, working with Southern Glazer, have done a great job with boots on the street, have done a great job of getting displays and getting products. And I think the big part of it is just we've got more and more products that we've been able to get into the stores. The big thing also is the relationships on that we've built in displays. I come back and say, the quality of our product has continuously improved and increased with our flowers, with our vapes, and when you gain share. So, distribution is number one, innovation is number two, and consumers becoming more and more aware of our products, they know our products and accepting it.

In regards to price, the big thing is, you have to promote, you have to drop the prices when your product does not sell up. And that's not been our case right now that we've not had to go out there and discount our products because our products are selling. Our biggest complaint is, we can't find our products or we're out of stock.

Carl, you want to add anything?

Carl A. Merton
Chief Financial Officer, Aphria, Inc.
A

And I'll just add that we haven't seen the pricing pressure, as Irwin said. And I really think that's a function of how we've priced all of our brands. And when you look in each segment that those brands are competing against, they're all priced competitively against the other brands in the space. We're not trying to sit out there and take the number one, number two selling price inside of a segment. All of them we are kind of median or just slightly below it. And I think that's a big part of our success as well.

Aaron Grey
Analyst, Alliance Global Partners Corp.
Q

All right. Great. Appreciate that. And certainly [indiscernible] (00:49:24) market share gains. If I can just squeeze in one more. Just as we look at the fourth quarter, I can certainly appreciate the decision to suspend guidance. But as we think about all the puts and takes, you do have some more stores that have come online, some continued market share gains, but obviously a lot of unknowns with COVID, which has been impacting for about a month now. If everything were about to stay as it is now for the remainder of the quarter, in terms of curbside pickup, delivery and with store are closed now, how would you see in terms of purchases [ph] from provinces and (00:49:57) how do you expect kind of sales to trend sequentially? So any color there would be helpful. Thanks.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.
A

So, we pulled the guidance, Aaron. There was a reason we did that or we suspended the guidance. There are – there is just so much uncertainty. Individual control boards, when you talk to them, some are seeing things go up, some are seeing sales go down, some are just trying to be careful to make sure that they don't have excess amounts of inventory in this piece. And so, I think you're seeing a move at the control boards to lower purchases on an individual purchase with a greater cadence of purchases, just to be safe.

They've learned from what happened in the 1.0 rollout. They're just buying product because it's available, is it an effective strategy for them. And that's what we're seeing. But it just – it does – it puts us in a position where we just aren't able to comment on what that looks like other than providing the pieces we provided in the call, where we gave you the little pieces in each individual country of what we're currently experiencing. The real problem is nobody knows what we're going to experience tomorrow.

Aaron Grey
Analyst, Alliance Global Partners Corp.
Q

All right. Great. Appreciate that.

Operator: Our next question comes from the line of John Zamparo with CIBC. Your line is open.

John Zamparo
Analyst, CIBC World Markets, Inc.
Q

Thanks. Good morning, guys. I wanted to follow up on the wholesale...

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.
A

Good morning.

John Zamparo
Analyst, CIBC World Markets, Inc.
Q

Good morning. I wanted to follow up on the wholesale question from earlier. At what point do you think you'll get to sourcing all of your products internally? Is it likely to be in fiscal Q4 or later in 2020? And then, selling wholesale, can talk about market conditions there and the sale that you had in the quart, I mean, do you view this as somewhat sustainable or should we view it as kind of opportunistic and one-time?

Carl A. Merton
Chief Financial Officer, Aphria, Inc.
A

So, I think I said during my remarks, we don't anticipate duplicating that wholesale's sale. It was kind of a one-time position. We had excess inventory in one very specific part of our inventory, and we wanted to make an adjustment there, and so we sold it to someone who was looking for it.

As it relates to purchase flower, we have taken advantage of that market when it proactively benefited us. That was primarily in Q3, and we have a little bit left over that's going to be available for Q4. Our intention is not to be in that market. We have – the capability improves up to 255,000 kgs from our two facilities, buying more on a long-term basis doesn't make sense. It just – it made sense in this very limited short-time opportunity.

John Zamparo
Analyst, CIBC World Markets, Inc.
Q

Okay, that's helpful. Thanks. And then, my second question is on the derivative side. It sounds like you've had some good results from your vape portfolio so far. I'm just wondering how do you think about keeping your share lead once additional competitors arrive and at what point do you expect to launch here your edibles and topicals portfolio, I saw it was mentioned in the MD&A, just trying to get a sense of when we might see that? Thank you.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.
A

So, I think some of the Q2 products that you're going to see come online at the end of the first half of the year. We have some other ones that we continue to move forward with, that will follow after that. We want to get these right. We did a critical analysis last year, we looked at our capabilities, we looked at what the market wanted, and we saw a huge opportunity for us on vape. And we said, we're going to get that one right. And we're going to just do one. And then, we're going to move to each additional area. And when we do it, we're going to do it right.

And so, we've taken a little bit slower focus than some people have to make sure that the products that we release are what consumers want and that they're done right. When it comes to vape and differentiation, we believe it's about the terpene blend. And so, we've been – we've done a lot of – we did a lot of testing on alternate flavors and things like that, that would be appealing to consumers. And we continue to differentiate ourselves that way.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.
A

And I think it's important. Listen, our brands stand for something. And when we come out with a product, they've got to meet the standards of our brands from uniqueness, it's just not a me-too product. And that's what's going to be important what we come out with. I think there's a lot of companies at play beat the clock to get products out there. And with that, we're going to get the right product, something different, something unique and products that we're going to be able to get pricing and value for.

John Zamparo
Analyst, CIBC World Markets, Inc.

Q

Okay. That's great. Thank you very much.

Operator: Our next question comes from the line of Pablo Zuanic with Cantor Fitzgerald. Please go ahead. Your line is open.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Good morning, everyone, and congratulations on the quarter, especially on the sales front.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you, Pablo.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

When you talked about the M&A side of things, can you clarify that a little bit in terms of looking at distressed assets in Canada, and what specifically are you missing? And related to that, you only own 51% of Diamond, does it make sense to buy the other 49% at some point, especially as you begin to use that facility? And then, I have a follow-up. Thanks.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

So, number one, I think, listen, there's lots of investment that we need to assess that may make sense to be a part of Aphria and we'll look at that and where does that come from. And I think as we look at – there is opportunities within medical, there is opportunities within the other processes. We have a tremendous amount of grow, we have over 265,000 kilos that we can grow today. But I think with any industry, consolidation is important and consolidation is going to happen, and I think that's going to be something that's going to happen in the cannabis industry and that's going to be happening where there's a smart opportunity.

And Pablo, [indiscernible] (00:56:20) together was 55 acquisitions, so that's something we will look at, where is there an opportunity to buy distressed assets or assets that are way undervalued.

In regards to Aphria Diamond, we have a great partner in the Mastronardis. And I think partnership is not only owning the 100%, it's also owning and having partners that really can be helpful with your growth, really helpful in regards to how you run the facility. So, there's no need for us to go out there and buy the other 49%, because right now we're able to get good grow, good products and good partners, and why would we spend our money to do that.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Understood. And just a follow-up on 2.0. Just to be clear, remind us of – in the February quarter, you have your full lineup there in terms of vapes, or was it rolled out through the quarter? I'm just trying to – I understand most of the launches won't be until June, as you just said, but is there a difference in terms of how much product you will have out there in the May quarter versus the February quarter? Thanks.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Well. So far, it was minimal and really didn't start till January, and some in February. But the quarter – the April – the March, April, May quarters are the big quarters that we're going to be rolling our product, and that's where the majority of our vape will be in the next six months, but this will be a good sized quarter for vapes.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Understood. Thank you.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Operator: Our next question comes from the line of Graeme Kreindler with Eight Capital. Please go ahead. Your line is open.

Graeme Kreindler
Analyst, Eight Capital

Q

Yeah. Hi. Good morning, and thank you for taking my questions here. Just as a follow-up on the derivatives. I'd like to get – if you could provide some color on the production capacity right now for derivatives and 2.0 products, kind of from the extraction angle down to downstream packaging. And given the commentary on COVID-19 as well as the CapEx, I'm just wondering if that's going to impact any incremental licensing that might be required to ramp up production of vapes; as well as, given the market conditions, does that – will that inform any speed up or slowdown of product launches as we see what happens at the brick-and-mortar angle here? Thank you.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

So, there may be some other licenses and opportunities out there as continuously we're looking at interesting technology out there and better vaping opportunities. We're also looking at potential partnerships out there as some of the other companies that do vape today realize cannabis is going to be something that's here to stay. So, there is opportunities in partnerships, opportunities in innovation, and we're seeing a lot of new technology out there. And we look to improve product and improve performance.

And vaping will be a product that's going to be used in so many different occasions. And in regards to our other products, again, we we've been a little slower than some of the other companies, but it's been because we want to make sure we perfected the right product and we've got the right product and they should be rolling out in the second half of our fiscal year 2021.

Graeme Kreindler
Analyst, Eight Capital

Q

Thank you. And just to clarify. In addition, when talking about licensing in particular with Health Canada, are there any areas that you're currently waiting for licensing that's going to help on the processing side of things and, yeah, has the COVID-19 situation impacted any of the expected timings of when you might receive that licensing if that's the case?

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Nothing significant. We're always potentially looking for licensing in certain processing rooms and certain processing areas. But it's nothing like a license that we're waiting for Aphria Diamond or nothing that we're waiting for from an Aphria One or something like that. There could be some small licenses we're looking for in certain rooms within Aphria One or Aphria Diamond, but nothing that will hinder any of our growth in any of our major processes.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay. Appreciate the color. Thank you very much.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Operator: Our next question comes from the line of Matt Bottomley with Canaccord Genuity. Please go ahead. Your line is open.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Yeah. Good morning, Irwin and Carl. Congrats on a very encouraging quarter here.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Just want to go back, Carl, to some of your commentary with respect to the lack of write-offs and impairment, and that's something that obviously has been challenging in sector-wise, with a lot of downward surprises by many of your peers. So, just curious on maybe the rationale and the philosophy of when you guys bring that biological asset into inventory. I don't know if you can get into the details of pricing assumptions, but maybe just the overall – the methodology of how you're confident that the way you're costing that is ahead of the curve, given what many anticipate is going to be a commoditization as the sector evolves. I think that you commented in the past that you're not as bearish on that, particularly with your product lineups. But just to mitigate maybe potential future risks of impairments, just given how much capacity is out there.

Carl A. Merton
Chief Financial Officer, Aphria, Inc.

A

So, I think one of the key pieces is that, when we started as a company, we've always taken most likely the most conservative view of fair value. And as a result, we haven't had to pay the price that other people have had to pay for that aggressiveness. We've been very clear and transparent in our disclosure. In our financial statements, our cost structure has been lower than everyone else's. And so, our actual – the real costs, before you get into the artificial accounting costs of fair value, are generally lower than everyone else in the industry, to begin with.

And then, when you pair that with being very careful on the value that we're writing the product up to, which again, we provide full transparency on in the MD&A. It's just put us in a better position. We proactively are looking at where market prices are for all of our products. And if we – if there is a future need to adjust the fair value that we write the product up to, we'll deal with that. But to this point, those values have been easily recoverable. And I think it's just a function of not being aggressive early on.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Got it. That's very helpful. And then, just a quick follow-up and I think you had already commented on this a little bit previously. But when it comes to the Cannabis 2.0 rollout, just confirming that it seems like that that big healthy growth you saw in adult-use was more in the dried flower. So, I'm imagining there wasn't sort of any sort of step function increase this quarter on vapes; and if anything, we should anticipate a bit of that in your final fiscal quarter this year?

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Exactly. I mean, there's some vapes in the quarter. But the fourth quarter was no – the quarter we're in now which ends the end of May is where the big step up is in vapes and then in our first quarter in 2021. And then in the back half of 2021, our second quarter, third quarter is when we go into edibles and gummies and other products.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Got it. Thank you.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

A

Thank you.

Operator: This concludes the Q&A session for today's call. I will now turn the call back over to management.

Irwin David Simon
Chairman & Chief Executive Officer, Aphria, Inc.

Thank you very much, Kensey. Thank you, everybody, for today's call and spending time and listening to us. Listen, it's been just a year now that I've taken over as CEO, and it has been a really, really interesting year. It's been an interesting industry, and I've really enjoyed working with the people at Aphria. I've enjoyed working with our board. I've enjoyed very much working with our consumers, our analysts and the financial world. It's an industry that has tremendous amount of legs and so many different failures, whether it's recreational, whether it's medical, whether there's other medical aspects of it, et cetera, and I think what you'll see today is Aphria playing a big part.

Just think what we've been able to achieve within the year in regards to our brand building, in regards to our cash situation, our balance sheet, building out Aphria Diamond, completing Aphria One, building out Germany, building out LATAM and completing with that. So, with that, just as you give us more and more time, just think what we will be within the cannabis world. There will be consolidation, there will be additional partnerships that came in, and Aphria will be a big part of that.

But I think the most important thing is, we are in changing times. I've never seen this in my lifetime. I hope I'd never see this – something like this again in our lifetime. I think the one thing we got to take into effect, the consumer will change, our purchasing habits will change, the way we socialize with people, what we do with our employees, how we sell products. Aphria today is in a good place. We have revenue, we have brands, we have cash, and we're running every single day. We every day think about the safety of our employees. We think about what's going on in the world and how we give back and we will continuously give back in every way we can.

So, with that, I'd like to tell everybody please be safe. Please keep social distancing. Stay home, relax, enjoy some great recreational cannabis, enjoy some medical. And you'll be safe, happy, and look forward to talking to you real soon. So, thank you very much for today's call.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.