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CRON - Q1 2020 Cronos Group Inc Earnings Call

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MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Natalia, and I will be your conference operator today. I would like to welcome everyone to the Cronos Group's First Quarter 2020 Earnings Conference Call. Today's call is being recorded.

At this time, I would like to turn the call over to Shayne Laidlaw, Investor Relations. Please go ahead, sir.

Shayne Laidlaw - Cronos Group Inc. – Director, Investor Relations & Strategy

Thank you, Natalia, and thank you for joining us today to review Cronos Group's first quarter 2020 financial and business performance. Today, I'm joined by our Chairman, President and CEO, Mike Gorenstein; our CFO, Jerry Barbato; and our EVP of Legal and Regulatory Affairs, Xiuming Shum.

Cronos Group issued a news release announcing our financial results this morning, which are filed on our EDGAR and SEDAR profiles. This information as well as the prepared remarks will also be posted on our website under Investor Relations.

Before I turn the call over to Mike, I would like to remind you that our discussion during this conference call will include forward-looking statements that are based on assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements, including as a result of the factors described in the cautionary statement and risk factors included in the company's earnings release and regulatory filings, included in the company's most recent annual report on Form 10-K/A and quarterly report on Form 10-Q, by which any forward-looking statements made during this call are qualified in their entirety.

In addition, during this call, certain financial measures may be discussed that are not recognized under U.S. generally accepted accounting principles referred to by the Securities and Exchange Commission as non-GAAP measures. We believe these non-GAAP measures assist management in planning, forecasting and evaluating business and financial performance, including allocating resources. Reconciliations of these non-GAAP measures to their closest reported GAAP measures are included in our earnings press release furnished to the SEC, which is available in the pressroom section of our website, thecronosgroup.com. These non-GAAP measures may not be comparable to measures used by other issuers.

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

I'd also like to note that we are conducting our call today from our respective remote locations. As such, there may be brief delays, crosstalk or minor technical issues during this call. We thank you in advance for your patience and understanding. We will now make prepared remarks, and then we'll move on to a question-and-answer session.

With that, I'll pass it over to Cronos Group's CEO, Mike Gorenstein.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Thank you, Shayne, and good morning, everyone. As the COVID-19 pandemic continues to affect global markets and people around the world, we hope that everyone is staying safe and well during this time.

We would like to start this call by addressing how COVID-19 has affected us and how we as a company are adapting during this time. Our top priority continues to be the health and safety of our employees and our consumers as well as ensuring that we secure our supply chain. As we mentioned on our most recent call, we have assembled a global cross-functional internal taskforce led by me. We have been monitoring the situation daily in order to implement modifications as the situation evolves. The company has implemented business continuity plans to support its employee base while continuing to develop and produce reliable, high-quality products that meet and exceed the needs of consumers.

As of today, our manufacturing facilities remain open as governments in the regions where we operate have designated our business as essential. We are maintaining our work-from-home policies for certain employees until further notice, and we have a strict no-travel policy, including between our sites, which are deemed essential. In our manufacturing facilities, we enhanced hygiene and sanitation practices, modified schedules and have maintained social-distancing protocols. As circumstances vary by region and country, we are working diligently to continue to act in accordance with all applicable guidance from local, federal and international health and governmental authorities, and we are prepared to make additional operational adjustments as necessary.

We have donated surplus N95 masks, goggles, face shield head mounts and face shield replacements from our Peace Natural Campus to the Collingwood and Barrie area hospitals. Additionally, the Lord Jones team has distributed skincare products to nurses and doctors working in hospitals in New York, Miami, New Orleans and Houston. As a Company, we feel fortunate to contribute and are honored to give back to our communities and frontline health care workers to support them in their efforts to take care of COVID-19 patients. We will continue to closely monitor the rapidly evolving COVID-19 situation as well as how the opening of different regions will impact the business, our consumers, employees and our supply chain.

As you know, my focus and the company's focus are on creating long-term shareholder value by developing disruptive intellectual property and building iconic brands. I encourage long-term thinking, and especially in today's environment, we need to be planning for the future. Our value will come from technology breakthroughs and branded sales that help build and strengthen our relationship with our consumers. We believe that the best way to create value to the supply chain is by working with contract farmers and suppliers to support our capacity needs in global markets.

During the first quarter of 2020, Cronos Group's contract manufacturing joint venture in Latin America, Natuera, achieved significant operational milestones. As a reminder, Natuera is a 50-50 joint venture between Cronos Group and AGI, a company with multigenerational expertise in managing industrial scale agricultural operations for export from Colombia. Natuera completed construction of its state-of-the-art extraction facility designed to GMP standards. Natuera also gained preferential access to 4 cultivars registered with the Colombian Agricultural Institute. One of the hemp strains was planted in mid-February and harvest at the end of April. With its extraction and processing facility also coming online, Natuera's R&D department has developed its first commercially available hemp-derived CBD distillate, which was granted a non-controlled substance ruling by Columbia's Narcotics Control Board, streamlining and efficient process for export.

Natuera successfully completed its first test export to the United States in early March. The JV is focused on accessing new markets and product expansion, including developing additional bulk offerings of hemp-derived CBD distillate and water-soluble hemp-derived CBD solutions. Despite this being a small test shipment, we're very pleased with this joint venture and believe our approach to building a world-class, low-cost, scalable supply chain with partners like Natuera, positions Cronos Group to develop new business and trade channels in geographies like Latin America and other markets globally.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Let's now turn to discuss our latest developments in Israel. Subsequent to this quarter, in April 2020, Cronos Group completed its first export of bulk dried flower to Cronos Israel in order to sell PEACE NATURALS branded cannabis products for distribution in the Israeli medical market. Cronos Israel will begin to build its distribution network and brand presence in this rapidly growing medical market. Concurrently with building our brand presence, we have worked with our JV partners at Kibbutz Gan Shmuel to bring the Cronos Israel facility online and we are encouraged that this operation will become a growth driver for our business in the back half of 2020 and onward. We have received the necessary regulatory approvals to produce, manufacture and sell dried cannabis flower and are awaiting approvals for pre-rolls and oil products, which are expected to be received throughout 2020.

I want to provide a bit of color on the Israel medical cannabis market and why we are looking forward to bringing PEACE NATURALS's branded products to patients, which are expected to become available sometime in the second quarter of this year. Israel has taken several steps to optimize and expedite the patient access process for medical cannabis, and we are excited to join this thriving regulated market. The cannabis usage rate in Israel is among the highest in the world, and the medical patient count in Israel is expected to grow rapidly, which represents an excellent opportunity for our business to grow in this market.

In 2016, the Israeli Ministry of Health published a medical cannabis information booklet and guide, which includes a methodology intended for doctors to prescribe cannabis. This is meant to guide and assist in customizing treatment with medical cannabis. Many doctors in the Israeli health care systems have been trained and certified using this clinical methodology, which enables them to provide treatment and issue patients licenses for possession and use of medical cannabis. The Israeli Medical Cannabis Agency currently grants personal medical cannabis permits and prescriptions to patients to treat a variety of medical conditions. And unlike the Canadian medical cannabis program, patients fill prescriptions directly through pharmacies.

The existing sophisticated legal framework for medical cannabis in Israel coupled with a less established black market due to Israel's stringent border controls, makes an exciting and potentially lucrative opportunity for Cronos Group. In April, Cronos Israel entered into a collaborative agreement with Cannasoul Analytics, a cannabis research company dedicated to developing scientific intellectual property, medical products and technologies. Under our agreement, Cannasoul intends to develop a commercial cannabis analytical testing laboratory on-site at Cronos Israel.

Cannasoul is led by established cannabis researcher, Professor Dedi Meiri, from the Technion Israel Institute of Technology. Professor Meiri intends to operate the laboratory and conduct in-house commercial analytical testing for Cronos Israel and third-party clients. Once operational, the labs capabilities are anticipated to address the current gap and need in the Israeli market for accurate end-to-end cannabis analytical testing for both domestic sales and export to certain international markets. We are delighted to partner with Dr. Meiri again and to bring his expertise to the Israeli market.

Another initiative we remain excited about is our intellectual property work with Ginkgo Bioworks and our commitment to investing in cutting-edge breakthrough technologies in cannabinoid innovation. Every day, we move one step closer to our vision of creating cultured cannabinoids at scale using fermentation. Ginkgo has already filed patent applications, which pertain to the fermentation of cannabinoids in order to protect the intellectual property work we have developed to date through this partnership. As previously noted, we are the exclusive global perpetual licensee of the intellectual property covered by the patent applications for the 8 target cannabinoids outlined in our agreement with Ginkgo.

In the first quarter of 2020, Cronos Fermentation received an R&D license from Health Canada and received initial cannabinoid producing strains from Ginkgo Bioworks. Subsequent to the quarter end, Cronos Fermentation successfully fermented one of our target cannabinoids, CBGA, using the cannabinoid strains in our Winnipeg R&D labs. Cronos Fermentation will continue using these strains to optimize downstream processing and scale up procedures in advance of receiving the final strains and commercial processing license, both of which are required for commercialization. This groundbreaking work has the ability to transform our business and disrupt the industry in a variety of ways. First, it will allow us to be more cost competitive as we roll-out derivative products. As consumer demand shifts from flower to derivative products, lowering the cost of active ingredients will become critical to compete effectively against our peers and the illicit market. Second, fermented cannabinoids will deliver more consistent products. Like other consumer packaged goods companies, in order to develop trusted cannabis brands that resonate with consumers, it is critical that we deliver the same experience each time the consumer interacts with our products. We expect the fermentation platform to provide us with the manufacturing precision to deliver consistent cannabinoid blends and products. And third, we plan to leverage rare cannabinoids to provide differentiated products to consumers and become a leader in the growth of new product categories.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

In the long run, differentiated products will drive margin durability and market share. Rare cannabinoids will enable us to distinguish our products in existing categories. Additionally, leveraging rare cannabinoids as the primary ingredient in new product categories will allow us to expand the addressable market.

Having accomplished the milestone of successfully fermenting a cannabinoid at R&D scale at our facility, we continue to be confident in our ability to commercially ferment cannabinoids under our previously disclosed timeline of September 2021. We anticipate these cultured cannabinoids will one day, not only be an integral part of our supply chain, but also help our brand innovation potential reach new heights. This quarter, we continued to bring new innovative products to market and further establish our brand portfolio. Our goal is to deliver high-quality, consistent cannabinoid products to the market, while expanding how consumers approach and shop within the category.

Early this quarter, our luxury hemp-derived CBD brand, Lord Jones, launched the Lord Jones Acid Mantle Repair CBD Moisturizer to the U.S. market. This soothing facial moisturizer is formulated to help maintain the skin's acid mantle and rebalance the appearance of stressed skin. The brand continues to deliver on its promise of authenticity to consumers while launching new and innovative skincare products.

Toward the end of the first quarter, Lord Jones saw a shift to the direct-to-consumer online channel as well as online sales through its partner sites, as most brick-and-mortar luxury retailers have closed due to COVID-19 and subsequent social distancing orders. As an online-first business, Lord Jones has the existing infrastructure in place to meet the online demand for hemp-derived CBD products. Despite our readiness to adapt to the changing landscape, both near and long term, consumer behavior does not always shift as easily. We believe the beauty category could have lingering impacts in regard to product trials and purchasing as consumers in the skin care category, typically like to try it and retail before they buy.

In the Canadian 2.0 market, our direct-to-consumer medicinal cannabis brand, PEACE NATURALS launched new vaporizer devices in the first quarter. Our PEACE NATURALS brand has always kept quality as a top priority, and this commitment to quality holds true with our new vaporizer devices. These devices aim to deliver a premium extract for consumers with precise cannabinoid concentration levels and terpene profiles for a consistent experience. The premium cannabis extracts are made using CO2 extraction processes, and each product has a unique and aromatic blend, which uses all-natural terpene rich flavors. Our PEACE NATURALS batteries and cartridges are rigorously tested before sale, and we received positive feedback on the products to date.

We are proud of our uncompromising approach to quality, which is at the heart of everything we do. As we continue to glean more consumer insights into the Canadian market, we look forward to developing innovative and differentiated products that meet the needs and exceed the expectations of our consumers.

Turning to distribution in the Canadian market. In Q1, we continue to supply the adult-use market, working with provinces and private retailers to meet demand during this time. As COVID-19 has impacted global markets and various industries and supply chains, we have begun to see a contraction in demand as cannabis stores in various provinces have been either closed or are going through changes in how they are forced to operate.

In Canada, while certain cannabis retailers were designated an essential business, additional new measures have been implemented to permit click & collect and online delivery of cannabis products to consumers. Several provincial purchasers have similarly implemented additional health and safety measures and reduced staff at on-site operations, including limiting delivery time slots, which has posed logistical challenges and created a reduction in purchase order fulfillment. The slowdown in disruptions faced by retailers is also in addition to quarantine measures and travel restrictions, which could impact the ability of consumers to readily access our products outside of the online channel. These restrictions will continue to change and evolve, which creates uncertainty in forecasting consumer demand and sales velocity.

As mentioned in the U.S., while online sales continued, most beauty and luxury brick-and-mortar retailers have temporarily closed their stores and boutiques. However, Lord Jones has adapted during this time, and has made and will continue to make modifications to meet the online sales demand in this environment. Through these challenges, we continue to modify and monitor our distribution networks to bring quality products to market during this unprecedented time. We understand that this disruption is impacting everyone, but we are committed to providing our consumers with the level of consistency and stability with our products that they have come to expect from our brands and from us.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

With that, I'll turn it over to Jerry to provide a discussion on this quarter's financial results and our remediation efforts.

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Thanks, Mike, and good morning, everyone. Turning to our financial results. The company reported consolidated net revenue in the first quarter of 2020 of \$8.4 million, a 181% increase from the prior year period. Revenue growth year-over-year was driven primarily by increased distribution of cannabis products in the Canadian market and the inclusion of financial results of Redwood, our U.S. hemp-derived CBD business that was acquired in September of last year.

Consolidated gross profit for the first quarter of 2020 was negative \$6.5 million, an \$8 million decline from the first quarter of 2019. The decrease versus prior year was primarily driven by unfavorable pricing dynamics observed in the Canadian market that led to an \$8 million inventory write-down on dried cannabis and cannabis extracts within the rest of world segment as well as an increase in the marginal production costs at the Peace Naturals Campus, as we continue working towards operating at full capacity after the repurposing of the facility in the fourth quarter of 2019. If we were to exclude the inventory write-down of \$8 million, gross profit in the first quarter of 2020 would have been \$1.5 million, representing a gross margin of 18%. As we noted in our fourth quarter 2019 earnings, we anticipate inventory write-downs to continue in the short term due to pricing pressures in the marketplace.

Reported operating loss for the first quarter of 2020 was negative \$45.1 million, representing a \$34.9 million decline from the first quarter of 2019. The loss was due to a combination of factors, including: general and administrative expenses as a result of increased headcount, sales and marketing costs related to the development of new and existing brands, R&D expenses, mainly due to the costs associated with our Ginkgo partnership and spending on innovation at the Cronos Device Labs research and development center. Additionally, internal review costs of \$4.4 million, which was included in G&A related to the restatement of our 2019 financial statements. Our consolidated adjusted operating loss for the first quarter of 2020, which excludes the onetime internal review costs, was negative \$40.7 million.

Turning to our reporting segments. The Rest of World segment reported net revenue in the first quarter of 2020 of \$6.3 million, a 108% increase from the prior year period. Revenue growth year-over-year was driven primarily by increased distribution of cannabis products in the Canadian market, including the launch of cannabis vaporizers in both the adult-use and direct-to-consumer categories. Gross profit for the Rest of the World segment was negative \$7.6 million, a \$9.1 million decline from the first quarter of 2019. The decrease year-over-year was primarily driven by increased marginal production costs at the Peace Naturals Campus as well as an inventory write-down on dried cannabis and cannabis oil. If we were to exclude the \$8 million inventory write down, gross profit in the first quarter would have been \$0.4 million, representing a 6% gross margin.

I want to take a moment to address the gross margin in the Rest of World segment. As discussed previously, certain facilities at the Canadian Peace Naturals Campus have been partially repurposed from cultivation to provide additional space for R&D activities, manufacturing of derivative products as well as increased vault and warehousing capacity. Separately, we are also continuing to ramp up our purchases from third-party cannabis producers in order to fully realize the benefits of our asset-light model. As we work to create an efficient global supply chain through 2020 and beyond, for our Rest of World segment, we anticipate that gross margins will continue to fluctuate and experience pressure. This is due to the current underutilization of certain manufacturing facilities that are being repurposed and the work is still underway to streamline our third-party biomass supply chain. We anticipate that these operational pressures will ease as our manufacturing and purchasing teams continue to make progress in these areas.

Turning to our Canadian cannabis vaporizers, we made the strategic decision with our launch to utilize contract manufacturers to increase speed-to-market at the onset of Cannabis 2.0 legalization. Further, we believe that contract manufacturing allows us to be more flexible and responsive to trends in the marketplace, while also aligning with our asset-light model. We continue to work with contract manufacturers to reduce costs and streamline inventory movement, and we anticipate continued improvements to the gross margins of our vapes throughout 2020.

Reported operating loss in the Rest of World segment for the first quarter of 2020 was negative \$31.9 million, representing a \$21.7 million decline from the first quarter of 2019. The loss was primarily driven by increased general and administrative expenses as a result of increased headcount, higher sales and marketing costs related to building and developing existing brands, and higher R&D expenses in pursuit of our strategy.

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Our teams in Canada worked diligently each day to properly configure and enhanced our cannabinoid supply chain. We are creating an industry while simultaneously executing a strategy that differs from our industry peers. We continue to believe in our strategy and its merits for long-term value creation.

Turning to the U.S. segment. Reported net revenue in the first quarter of 2020 was \$2.2 million. Gross profit for the U.S. segment was \$1.1 million, representing a gross margin of 50%. Reported operating loss in the U.S. segment for the first quarter of 2020 was a negative \$6.5 million. The loss was primarily driven by increased sales and marketing costs incurred in relation to the introduction of several new U.S. hemp-derived CBD products under the Lord Jones brand and an increase in headcount to support growth initiatives. Overall, Cronos Group reported a decrease in net income from the prior year, primarily due to the change in fair value of the financial derivative liability associated with Altria's investment, which is described in more detail in the 10-Q.

In the first quarter, the company recorded a noncash gain of \$113.4 million related to the change in fair value of these financial derivative liabilities. Cronos continues to expect there may be significant reported earnings volatility, primarily driven by the fair value quarterly adjustments related to the movement of Cronos Group's stock price.

Turning to the balance sheet. The company ended the quarter with approximately \$1.3 billion in cash and short-term investments, representing a \$171 million decline from the fourth quarter of 2019. The majority of the decline was due to the impact of volatility in exchange rates. The U.S. dollar strengthened significantly against the Canadian dollar since the beginning of the year from \$1.30 at December 31, to \$1.41 at March 31, 2020. In the long term, this is not meaningful to our business, and we can expect to have fluctuations in currency in the short-term and generally going forward.

Capital expenditures for the quarter were \$7.5 million. This spending includes investments in our Peace Naturals Campus, Cronos Fermentation, our Israeli facility and device technology innovation at Cronos Device Labs. We remain focused on deploying capital in a disciplined manner and only in ways that align with our strategic priorities.

Lastly, I would like to provide you an update on our remediation efforts in relation to the material weaknesses that we disclosed last quarter. We as a company are committed to instituting best practices for financial reporting. Our management, with oversight from the Audit Committee, has initiated a plan, which we are working diligently to phase in over the course of 2020.

I will now take you through some additional detail of our remediation plan for each of the 3 material weaknesses we disclosed last quarter. First, we are making considerable enhancements to the quarterly review of our risk assessment model and risk controlled matrices, while also establishing a risk committee that will review the risk assessment on a quarterly basis. Secondly, we are enhancing the delegation of authority policies to limit the number of groups that can authorize sales or purchases of inventory. We're also establishing a review process and an internal database to identify entities that are both vendors and customers of the company. And lastly, we are in the process of creating and implementing a non-routine transactions policy that will clearly define non-routine transactions with prior accounting memo completion and will require CEO and or CFO approval.

Business operators will be required to provide formal business cases for all non-routine business-to-business, unbranded sales and purchases. These business cases will be reviewed quarterly to ensure alignment with the objectives of the company. We will also be expanding the sub certification process to additional members of management to ensure that non-routine transactions are correctly identified and accounted for. As we implement these controls, they will be rigorously tested internally and by our independent auditor to ensure they are working correctly. We are confident in the remediation plan that we are implementing and believe we will be a stronger company as a result of this undertaking.

In closing, we expect to continue to invest in our strategic initiatives, and we remain optimistic about our near-term plans to achieve long-term leadership in the cannabis space.

With that, I'll turn it over to Mike for closing remarks before Q&A.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Thank you, Jerry. Cronos started 2020 off energized and determined to continue to execute against our strategic initiatives to drive sustainable growth and long-term value. Despite the challenges and uncertainty posed by the COVID-19 pandemic, we remain focused as a business and agile unless required to leave our homes. Our brand portfolio continues to launch innovative products to consumers as we adapt to an online-first distribution model in both the U.S. and Canada. We continue to reach our stakeholders and consumers through creative digital marketing. We believe the mission of our company to improve lives through cannabinoid innovation resonates especially well, and we feel very fortunate to be able to provide consumers with our products during these times. We remain well positioned and committed to generating sustainable long-term value for shareholders and are confident 2020 will be a successful building year for Cronos.

With that, let's now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

The first question is from the line of Andrew Carter with Stifel.

William Andrew Carter - Stifel, Nicolaus & Company, Incorporated, Research Division - Associate VP

I want to focus in back on the Lord Jones or the U.S. kind of platform. It came in, it's down sequentially from the last quarter and essentially flat from kind of what it was in the third quarter. There's a lot of moving parts. Obviously, shipments are down to some of the stores that are closing. But what can you offer and there's some new product launches as well, what can you offer in terms of growth from kind of existing customers in your direct-to-consumer channel? Or anything just to kind of offer some evidence that, that brand is kind of resonating and growing?

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Thank you, Andrew. Although it was a bit disappointing to see the decline in the U.S. business, we feel confident in the plans that the business has to correct the trajectory, including, but not limited to building consumer awareness of new and existing products, such as Mike mentioned in the prepared remarks, our Lord Jones Acid Mantle CBD moisturizing cream, and an additional brand launch coming down the pike in the second half of 2020. The U.S. CBD market is a big opportunity for us, and we look forward to sharing more of what we have in the pipeline and with our consumers over time.

The other thing I want to talk about is the COVID-19 impact. While we have a big B2C business, we do have many retail partners, over 900, and a lot of those are closed right now. And while some of that has shifted to some online platforms, a lot of these are boutiques that don't have an online platform. So there could be some pressure, definitely pressure in Q2, and we'll see what looks forward in Q3 and Q4.

William Andrew Carter - Stifel, Nicolaus & Company, Incorporated, Research Division - Associate VP

And then just kind of talk about the other kind of key channel for your business. If I'm understanding your outlook for Canada, you're indicating some pressure to sales near term. I mean, how are you thinking about the opportunity from Canada and kind of positioning kind of the business this year? Is it -- should we think about short-term decline, but a very quick recovery once the restriction is lifted? Or are you also may be thinking about some lingering impacts obviously, delayed retail rollout, some closures, just how do you think about the channels development and positioning for it over the next 6 months to 1 year?

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. So I think long term, we haven't seen anything that changes our view of how the market will roll out in the next 6 months to 1 year, and I think things will be choppy. Part of the things we've seen is sudden changes and what distribution will look like. And it's pretty difficult to paint all of Canada with a broad brush, just given the different approaches, provinces have to responding to COVID. So I think that we can see some changes in product mix and pack sizes. And when we just think about the occasions, for consumers that they're going to be purchasing, keeping in mind more at home. So I think convenience formats is something that will be less of a priority, so maybe more of a shift towards flower.

And I think we're actually still going to see some store growth. We've seen some stores in Ontario continue, but I think it's less of expecting declines and maybe just -- while we were conservative in forecasting what the growth would be this year. I think it's likely that it would just be the expected growth may not be there. But I think it's given the asset-light model and the flexibility we have, I think we're confident that the strategy is still right and that we'll be able to be ready to hit the ground running as soon as things start opening back up.

Operator

Our next question is from the line of Michael Lavery with Piper Sandler.

Michael Scott Lavery - Piper Sandler & Co., Research Division - Director & Senior Research Analyst

Can you just talk a little bit more about CBG or CBGA? And you mentioned you want to be positioned with differentiated products, can you give us any maybe teaser of how that might look and what some of the things are that would differentiate it? And maybe specifically, partly how to educate the consumer on how to understand different from other cannabinoids?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. Thanks. It's a great question. We think CBG will have similar consumer purchasing habits to CBD. Like CBD, I think there's certainly still more research that's needed before making any specific claims. I think what we'll find is that a lot of the reasons consumers might be purchasing CBD will find that maybe will get a better experience from a specific need for -- from CBG. So there I think will be some element of better fulfilling what is today a CBD consumers' needs. But I think there's still also opportunity to expand some of the addressable market. So you could think of just the formats being -- from generally anything that's not intoxicating the cannabinoid to be kind of similar, whereas THC would be on the other side. So we've seen actually in some small quantities, CBG being available and then strong demand in the U.S. I think that we need to have more supply before being able to predict pricing dynamics, but we have seen it just given the scarcity being at a higher price point.

But we think there's 2 real ways to bring in to market. One is using CBG as a lead cannabinoid, being a unique category and differentiator. And the other is including CBG and highlighting it as part of a product mix with other cannabinoids.

Michael Scott Lavery - Piper Sandler & Co., Research Division - Director & Senior Research Analyst

Okay. That's helpful. And just a quick follow-up. Can you give a sense for what some of the -- you mentioned you foresee inventory write-down still to come. Can you give us any sense of order of magnitude of that risk? Is it similar to what was in this quarter? Is it more or less?

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Yes, we don't give forward-looking guidance. And so a lot of it depends on what happens in the Canadian marketplace with fair value.

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Operator

Our next question is from the line of Vivien Azer with Cowen.

Vivien Nicole Azer - Cowen and Company, LLC, Research Division - MD & Senior Research Analyst

Just a follow-up on the landscape in Canada. A lot of your competitors have introduced value-priced or discount or deep discount off rates. What impact are you seeing in terms of the overall pricing landscape given that competitive activity?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. I think it's certainly something we're seeing, and we're seeing price elasticity in certain categories. We do and we have always expected that in the flower category, we'll continue to see price compression. We think that from a platform perspective, a lot of the work that we're doing and have been doing in innovation with fermentation will position us very well to be able to continue to be price competitive and really be able to lead and generating value from those types of segments. But I think there's 2 things that are really driving the changes. I think one is certainly value. You have less cost when you're able to spread out the amount of product into larger pack sizes. But also the fact that we have consumers that are at home right now, I think you would see a shift to larger pack sizes relevant of -- or sorry, regardless of the shift in drastic shift in prices. So we think it's -- those 2 things are certainly catching on. And we don't think that for flower, we're going to see any drastic changes to that trend anytime soon.

When we look at other markets, the legalized markets in the U.S., what you tend to see is the price starts out quite high. When there is a high demand and low supply, you'll see that price come down over time. And then at a certain point, you'll see the price start coming back up and moving towards an equilibrium as you'll have operators start exiting. One of the reasons that we partnered with Mucci group for Cronos GrowCo is, I think, their ability to thrive in other produce markets where there are similar trends. And that's sort of how we're thinking of the flower market-shaping up in Canada.

Vivien Nicole Azer - Cowen and Company, LLC, Research Division - MD & Senior Research Analyst

That's really helpful. And just a follow-up to that. You mentioned the shift larger pack sizes with the stay at home orders in place that certainly makes sense and is consistent with what we're seeing in other CBG categories. But from a demand planning standpoint, Mike, are you assuming that there will be elevated levels of consumption at the longest stay at home is in place? How are you thinking about the evolution of consumer demand, given the current backdrop?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. We don't have enough data that would substantiate that. And I think while we certainly could see that as a possibility. There are factors that are difficult to predict, such as how much of the consumption and purchasing will come from the legal versus a listed market. And I think also, the product mix is a key thing for us to think about. And when we think of demand planning, just given the time to change pack sizes and change offerings and how long we think that would last for. We do factor in we're kind of looking at where -- since we're in Canada, I'll say where the puck is going, not where the puck is. And I don't know that a sustained shift towards large pack flower size is where we see the value going forward long term. We do understand that there is some element of that.

But I think, again, going back to convenience and usage, some of the benefits from formats we're very excited around where convenience does matter quite a bit, pre rolls, vape pens, edibles, I think that has lots of an emphasis. So our near-term demand planning is that there's just much more likely to be a mix shift than an overall product quality shift.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Operator

Your next question is from the line of John Zamparo with CIBC.

John Zamparo - CIBC Capital Markets, Research Division - Associate

I wanted to follow-up on the other question about CBGA. I think it's an interesting development. So can you talk more broadly about your biosynthesis strategy? And let's say you achieve the milestones that you referenced, Mike, or even faster than you expect, are there additional steps you need to monetize and commercialize that research? Do you need regulatory approvals? Or can you launch products as soon as you get them? And if this requires more work with Technion or Cannasoul not now I guess? Just anything you can provide us with help frame that strategy would be helpful.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. Thanks, John. So I think there's a few ways you could think about it. The first, if you think about THC or CBD or even CBG, we've been able to see some limited data on how the products are used. For products that we have out in the market today or even product that we'll be launching regardless of fermentation. Anything other than flower, we're still able to just substitute fermented cannabinoids, they're completely fungible. It's the same exact molecule with extracted from cultivation cannabinoids. So I think out of the gate being able to monetize is not something that we need anything outside of the commercial processing license at the facility in Canada, that would just be the same as if we had a third-party -- or sorry, like a second site for extraction, the process we need to go through, it's actually specifically outlined in C-45 that for processing cannabinoids can come from biosynthesis. So we see it as fungible and something that can move into the supply chain instantly. I think there is further research and work that we're doing now is when we think of products where we're using the rare cannabinoids as a lead product. So if we were to launch a THCv vape pen, where THCv is primary cannabinoid and a new-to-world formulation, that's research, we're still working on now. The skincare research at Technion. Certainly, that's -- work still needed to be done there. While we're excited about it. We still have ways to go. But the other way that we would leverage rare cannabinoids, when I talk about just swapping it into our supply chain, if you were to look at the breakdown of ingredients and any popular cannabis product today -- I should say, most cannabis products today, what you'll see is, while THC and CBD will be the 2 primary cannabinoids, as you go down from a lab print out, you'll see that CBG, CBC, CBDV, THC, all the Ginkgo targets are, actually in there. And when you think of the entourage effect and what consumers look for, for this differentiated experience, when you say, I want a White Widow versus Northern Lights, it's really those cannabinoids and the terpenes that are driving that unique effect and that unique blend that consumers want. And it just gives us the ability in our supply chain to be able to make sure that we provide that unique blend each time and just deliver the same experience. So from that perspective, there aren't changes we need to make. But certainly for new-to-world formulations. There's still research we'll be doing. And I suspect and hope that there will be research we'll be doing for years and can continue to build our innovation pipeline as we they're able to test and refine and perfect offerings.

John Zamparo - CIBC Capital Markets, Research Division - Associate

All right. That's very helpful. And then my follow-up's on the brand building side. Just want to get a sense of how you think about building brands in the current COVID environment. You've talked in the past about launching additional brands through the Redwood family or Redwood asset, but your distribution partners are pretty restricted right now. So does this defer the brand launch until 2021? Or was that kind of the game plan anyway?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

I think there are certainly things that can cause delays in how we might otherwise launch or maybe an optimal launch. But it is a reality we have to deal with that this can stretch out for a long period. So we certainly have contingency plans. We feel that when we look at the brands in the portfolio and think of just timing. There are certain elements to the brand we would launch where we think we're able to get awareness without having what wouldn't be optimal without having a retail presence. So I think is digitally native and brand-leveraging DTC and being able to use social media, there are a lot of ways that we still can launch and plan on launching DTC, of course still monitoring situation, if that's the only available avenue to us.

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Operator

Your next question is from the line of Rahul Sarugaser with Raymond James.

Rahul Sarugaser - Raymond James Ltd., Research Division - MD and Equity Analyst of Healthcare, Biotechnology & Cannabis

Mike and Jerry. So congrats on having tech transfer from Ginkgo to the Winnipeg facility. That is, of course, an important milestone and seems to be an evolving part of your strategy. So we're recognizing that the first cannabinoid at CBGA, and so I wanted to sort of probe a little bit further into how many additional cannabinoids do you expect to be tech transferred over to going to Winnipeg facility over the next year and as you approach that September 2021 timeline?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. Yes, I think we -- without getting into specifics of how many have actually been tech transferred to date, I would just say we do expect that we would have by next year in September 2021, all of the cannabinoids transferred in the different strains. I think for us, the most important part of the milestone is just the general fermentation process. And if you think about the -- just how similar our targets are as far as the molecule, it's being able to start working on the scale-up and downstream processing, being able to work out what the kinks are and where potential bottlenecks are from fermenting or harvesting or separation and just being able to get the conversion of the strain to the broth to the purified cannabinoid, so that process of the important thing is that having a strain in a cannabinoid, but the molecules are so similar that we don't see any difference in what those processes really are going to be. But we still expect timeline-wise, that we'll be able to bring things to market September 2021.

Rahul Sarugaser - Raymond James Ltd., Research Division - MD and Equity Analyst of Healthcare, Biotechnology & Cannabis

Great. And just a quick follow-up question then. Do you expect that those first-generation products will be purely synthetic? Or do you think you'll be using a combination formulation of some synthetic as well as some botanically derived isolates?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Yes. And I think it's tough to answer, and it could be a combination. I do think that for a lot of products, there are some benefits to still having some of the fats and waxes and terpenes that are there. But ultimately, what the product mix will be, will be dictated by consumers. And so we think there are benefits to being able to make sure that we balance out and make our offerings consistent. We haven't seen that isolate products are necessarily something that there's a lot of consumer interest in today. So it would be the combination of cannabinoids that are fermented or a combination of fermented and botanical but I would say more likely from consumer research that in the early stages as we ramp up and think about run on run off times and changing different cannabinoid runs and working out efficiencies that it would start off as more of a blend.

Operator

Your next question is from the line of Owen Bennett with Jefferies.

Owen Michael Bennett - Jefferies LLC, Research Division - Equity Analyst

Hope you're all well. And my first question is just on the write-downs and where you're expecting more in additional costs. I was just wondering what your thinking is there and why, given the arguably increased scrutiny on your reporting, now you don't take one large write-down up front, like a lot of your peers teams be doing?

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Yes. Thank you, Owen, and good morning. Well, as you can imagine, this is a pretty dynamic time for the company as we're retooling our Canadian business for 2.0 products and expand on our third-party biomass purchasing strategy. And I'll point you back to the factors that we laid out in our prepared remarks, such as the near-term underutilization of the Peace Naturals Campus and the stabilization of our third-party biomass supply chain. Essentially, you've seen this with others in the industry, your gross margins can be impacted when facilities are not being utilized for their full capacity. This is just a product of the fact there's not enough revenue to cover the facility's fixed costs, we see that improving as the year goes on.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

One thing just to also say. There are some still fixed price contracts that are being worked out, and it's just our expectation that we'll continue to see price compression on the supply side. And I would add, when comparing to competitors, one thing just to be mindful of is, I believe that we only have one other competitor that reports in GAAP right now. So I think that we -- the way that we approach accounting is likely different than the majority of the competitors that are still under IFRS.

Owen Michael Bennett - Jefferies LLC, Research Division - Equity Analyst

Okay. And then I guess my follow-up to that is, you've spoken about the ongoing shift to value the price compression, given the likelihood of further write-down, it does seem that there's a little sell-through for your flower right now, and it remains one of the most expensive in the market. I was just wondering, I mean, what is your strategy there? Are you going to keep prices where they are? Are you going to lower them because of the lack of sell-through? I mean, if it's the former, it does appear like you're almost writing off the flower business in the hope of, obviously, you talk about these value-added products and when they start to come through and revenues materialize from them.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Yes. No, I think just for competitive reasons, we're not going to speak to what our pricing strategy will be going forward. But of course, something that we constantly evaluate and want to make sure that we stay competitive in the marketplace and are fulfilling consumer needs.

Operator

Your next question is from the line of Matt Bottomley with Canaccord Genuity.

Matt Bottomley - Canaccord Genuity Corp., Research Division - Analyst

Just wanted to dig a little deeper in the domestic cannabis sales or penetration this quarter over last. So I know you had some in your -- some details in the prepared remarks, but you had a decent bump as a percentage going up to \$6.3 million. But still in absolute dollars, I would have anticipated potentially a bigger bump given the 2.0 product introduction. So if you can maybe just give us some color on the quarter-over-quarter growth lining up what happened with the vape pens? And then also how much contribution might have shifted to incremental international sales? It's still unclear to me how much exports in the period might have been in that number?

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. So -- and I think one thing that to look at is, how much I think we saw on growth of branded sales and penetration. I think we have certainly seen a little bit of a mix shift, given that purchases were -- or did not include 2.0 or included a small amount of 2.0 and now consumer's having the option of both. But I think that things are -- things are going well as far as how well the vape pens are received, and it's something that we expect to ramp up throughout the year. As far as international, we actually haven't seen any changes in demand for exports. It's really scheduling logistics.

MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

But when we look forward at growth, we are adding a new region. And I think when you think of all the different medical markets that have launched, Israel is despite sort of being a new commercialized market. It's something where we've had a lot of infrastructure. And I think the regulators have done a very good job of making sure that it's something that's successful, both for medical patients and for businesses. So we do expect growth to come from Israel, I would say, starting initially with the flower that we've exported. But we do have our facility up and running and have been able to get harvest out.

So given the shortage there and what we've seen to be a fair amount of demand without having much of a black market compared to what we see in North America. We expect growth to come there. But I would say that it's not purely coming as an export market. A lot of that will come from the domestic cultivation, but depending on where demand levels out, it could still be a mix of export and domestic cultivation.

Matt Bottomley - Canaccord Genuity Corp., Research Division - Analyst

Got it. And then just as a follow-up, maybe just any color on pricing, whether in dollars or just as a ratio to what you see in the Canadian medical market. I know the pricing you had historically in Germany was very favorable. So just curious how that works in Israel.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Yes. I think it's not going to be as high as Germany. I think Germany is pretty unique. I would say that we expect and when you think of it, and I don't want to sound like an economics professor, but there's not a unique barrier like there is in Germany because of the way the pharmacy system works and sort of it almost freezes prices. So we have seen in markets like this that there might be a shortage of high price, but we're really focused on building a relationship with the consumers and the patients and getting early market share. It's a market we plan on really leaning into.

So I would say prices are going to be closer to what we're seeing in Canada, at least the way we think of setting prices. But we do expect the cost of production to be lower in Israel and I think we've highlighted that in previous calls just given the climate. So we expect that there's still a good margin opportunity. But over time, we would expect to see similar trends as far as product mix is what we've seen in Canada because it's -- from a regulation perspective, similar with the key difference being going through pharmacies rather than direct to patient. So maybe it'll shape out somewhere between where the adult use and the medical market in Canada is.

But I do think Germany is in its own category, given the more traditional pharma model.

Operator

Your final question is from the line of Graeme Kreindler with Eight capital.

Graeme Kreindler - Eight Capital, Research Division - Principal

I just wanted to follow-up with respect to the U.S. CBD pipeline launches expected for the second half of 2020. Traditionally, Lord Jones has been placed as more of a premium brand. And I was wondering if there are any plans to launch more of a mainstream or value type product, given potential for economic headwinds because of COVID-19.

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Yes. Thanks for the question, Graeme. Most definitely. Lord Jones obviously plays in that super premium category with a high price. And so as we look about the consumer segment, that is definitely a big opportunity for us is launching a much more mainstream brand, and that is definitely in our plans.



MAY 08, 2020 / 12:30PM, CRON - Q1 2020 Cronos Group Inc Earnings Call

Graeme Kreindler - Eight Capital, Research Division - Principal

Okay. And then as a follow-up question here. I was just wondering, given the recent developments at Altria and the changes in leadership there, can you just provide a bit of color in terms of the relationship between the 2 companies? And any sort of discussions that have had during transitions or as the business mix continues to develop there. That would be helpful.

Michael Ryan Gorenstein - Cronos Group Inc. - Chairman, President & CEO

Sure. I think there haven't really been any changes in the discussions. I think the team that's there from our perspective is a team that's -- it has been there since we've had the relationship. So -- and I think Jerry is also probably uniquely connected with people there. But I think that there's been a lot of consistency with tenure of the executives there. And so we haven't really had many changes in discussions. I think a lot of what the last few months, we've been focused on is we've been getting a lot of help from a lot of the folks there in counterparts. I'm just thinking through COVID, thinking through potential impacts, thinking through what best practice can be in manufacturing and making sure we have the right procedures in place to focus on employee safety and how to deal things. So I think it's been a very collaborative relationship, and I think we've been very fortunate to be able to lean on their expertise and how to deal with pretty uncertain times. But high level, there haven't been any discussions and changes.

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Yes. I would add, it's been quite a seamless transition for us. And I think the collaboration between the groups continues, and it's probably even increasing.

Operator

There are no further questions. This does conclude today's conference call. Thank you for your participation. You may now disconnect.

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