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Cronos Group, Inc. (CRON.CA)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Andrea, and I will be your conference operator today. I would like to welcome everyone to Cronos Group's 2024 Second Quarter Earnings Conference Call. Today's call is being recorded.

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

Shayne Laidlaw

Senior Director, FP&A, IR and M&A, Cronos Group, Inc.

Thank you, Andrea, and thank you for joining us today to review Cronos' 2024 second quarter financial and business performance. Today, I'm joined by our Chairman, President and CEO, Mike Gorenstein; and our CFO, James Holm.

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

Before I turn the call over to Mike, let me remind you that we may make forward-looking statements and refer to non-GAAP financial measures during this call. These forward-looking statements are based on management's current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Factors that could cause actual results to differ materially from expectations are detailed in our earnings materials and our SEC filings that are available on our website, by which any forward-looking statements made during this call are qualified in their entirety.

Information about non-GAAP financial measures, including reconciliations to US GAAP, can also be found in the earnings materials that are available on our website. Lastly, we will be making statements regarding market share information throughout this conference call, and unless otherwise stated, all market share data is provided by Hifyre.

We will now make prepared remarks, and then we will move into a question-and-answer session. With that, I'll pass it over to Cronos' Chairman, President and CEO, Mike Gorenstein.

Michael Ryan Gorenstein

Chairman, President & Chief Executive Officer, Cronos Group, Inc.

Thank you, Shayne, and good morning, everyone. The Canadian market has been characterized by extreme cycles of supply-demand imbalances. In the early days of legalization, there was not enough supply to meet demand, which caused many investors and industry participants to measure value using metrics such as funded capacity. This essentially rewarded companies that were building large cultivation facilities with higher valuations, which they then use to raise more capital and build even more capacity. This plays a lot of industry focus on facility size, not on production efficiency or product quality. As a result, total supply quickly ballooned and significantly outpaced demand.

The industry structure and expectations were all set up with price assumptions that were 3 times to 4 times what they are today, and that created a market structure with high excise tax, high provincial margins and high regulatory fees. However, companies with inefficient production facilities, having already built significant capacity, had to capture significant market share for their business models to work and attempts to get that market share led to price compression.

Many of these companies continue to raise capital, albeit on much less attractive terms and hopes to survive long enough to benefit from expected tailwinds of attractive international markets opening or rationalization in the Canadian market. Some resorted to not paying excise taxes to artificially lower their cost of production and other lab shops to artificially inflate consumers' perception of quality via higher potency label claims. However, with global macro events taking priority with policymakers, many producers were not able to survive long enough to see benefits of new markets opening.

Over the last year, we have seen CRA begin to ramp up collections and enforcement against companies not paying excise tax and regulators crack down into lab shopping, forcing more facility shutdown and bankruptcies. And earlier this year, with regulatory changes in Germany and increased traction in the UK, we've seen international demand finally beginning to ramp.

As we've said in the past, there's a difference between available cannabis inventory and available inventory that is sellable as quality flower. While there's plenty of the former, there is now a shortage of high-quality desirable flower that is sellable to consumers in Canada. That is in part why in June, we announced the expansion of GrowCo to continue to fuel our global growth initiatives.

GrowCo has proven to be a leading cannabis grower, continually improving yields and hitting consistent and high THC levels that consumers desire. This investment, which will be funded by an additional approximately $51 million credit facility, will support the expansion of GrowCo state-of-the-art purpose-built cannabis facility to meet the growing global demand for high-quality cannabis flower, enabling growth opportunities in the markets Cronos operates in today, enabling future growth into new markets that open.

An important component of this transaction is that in Q3, Cronos will consolidate GrowCo and its financial statements. You've heard me speak at lengths in the past about the strong performance of GrowCo. Consolidated GrowCo will provide investors with additional information on this underappreciated component of our business.

Turning now to brand updates. When we launched our best-selling brand, Spinach, we strategically focused on specific consumer segments and product attributes, elevating the consumer experience. This approach played a crucial role in establishing Spinach as one of the most recognized and best-selling brands in Canada.

Our team has introduced thoughtful innovations across various categories, and I'm incredibly proud of what we've accomplished from a brand perspective this quarter. Spinach continued its exceptional performance in the flower category, and the Canadian market was 6.2% market share, led by popular genetics such as GMO Cookies, Wedding Cake and Space Cake in a variety of size formats.

In Q2, we introduced Spinach Grindz, a milled flower offering conveniently designed to be ready to roll or used in a variety of smoking and vaporizing devices. Ready-to-use milled flower offerings have grown in popularity in Canada, appealing to consumers seeking both value and convenience. Spinach Grindz caters to this growing demand by providing high-quality milled cannabis that saves time and effort.

Our commitment to quality, innovation and investment in genetic breeding keeps us at the forefront in the flower category. The macro trends show that pre-rolls will be the number one category in retail sales within the next few years. So winning there will be critical. The pre-roll category is an area of focus for us, and there is a lot of work and development going into this segment.

As we innovate and iterate in this space, we're especially proud of our recent launches under the Lord Jones brand, adding to the ice water hash infused pre-roll lineup with Sour Blueberry and Snow Lotus strains. What you see from us in the pre-roll category today is just the beginning, and we plan to bring new and innovative products to market in the future.

In the edibles category, Spinach had 15.6% market share in Q2. Our focus on developing innovative strategies and products in this category have been instrumental in our success. In Q2, we launched our first variety pack offering, the SOURZ by Spinach Tropical Party Pack, which introduces new gummies and bolder tropical flavors and the distinctive Spinach S shape.

These gummies have a perfect blend of sour and sweet and utilize Cronos' proprietary flavor of masking technology and feature three new dual flavors, Peach Passionfruit, Pineapple Coconut and Strawberry Guava. We're excited to introduce these great new products under our Spinach brand in time for the summer season when we know consumers want convenience and new products to try.

Also, a pivotal addition to our product lineup is the new SOURZ by Spinach Fully Blasted gummies, which offer the same great-tasting SOURZ by Spinach flavors, now with 10 milligrams of THC per piece. This product launched in select markets earlier this year but didn't hit Ontario, Canada's largest market, until July. We expect this to provide positive momentum for edibles portfolio now that it's more fully distributed.

In June, Health Canada published proposed amendments to the cannabis regulations, which currently limit edibles to 10 milligrams of THC per package. The proposed amendments would allow greater flexibility in packing together multiple packages of edibles, each containing up to 10 milligrams of THC within a larger package, which we would welcome as an option for our best-selling SOURZ edibles. We think this would be a great step in the right direction to provide the consumer with their desired pack sizes, which are popular in other adult-use legalized markets.

In the vape category, Spinach has a number four market position in the quarter with 6.8% of retail sales in the category. Spinach's performance in the vape category is led by our top-selling products such as Pink Lemonade, Blueberry Dynamite, Strawberry Slurricane and Rocket Icicle.

Under Lord Jones, our new live resin vape features the Gorilla Z strain, including a 0.5-gram trial size in convenience of a very sleek all-in-one device and the 1-gram stock-up size as a 510-thread cartridge, catering to enthusiasts who love the natural flavors of live resin and those adult consumers new to the category who want to give this new strain a try. We continue to develop this portfolio to bring differentiated flavor and cannabinoid combinations to market in formats and sizes consumers desire.

Turning our attention to international markets. Our Israel team continues to perform very well. The team in Israel has put in tremendous efforts to refine the health of our portfolio, manufacturing processes and pricing strategy, resulting in higher volumes of products sold and improved pricing for our hero SKUs.

In Q2, the team in Israel launched four new strains, GG4, Key Limez Punch, Pink Sherb and GMO Lite. Our success in Israel is fueled by our in-house genetic breeding program, which has elevated the PEACE NATURALS brand to a leadership position.

In May, we announced that PEACE NATURALS expanded into the UK via our distribution partner, GROW Pharma, a leading distributor of prescribed medicinal cannabis products. Supply in the UK market, which has the potential to grow significantly this year, is another milestone for Cronos as we enter and expand within international markets. We intend to establish PEACE NATURALS as a top brand in the UK as we've done in Israel and Germany. We remain focused on growing within the markets we have entered and expanding our portfolio of borderless products to those markets when allowed.

This quarter's achievements stem from our unwavering commitment to developing a portfolio of borderless products, supported by strategic infrastructure and global partnerships. Our long-term approach of investing in borderless-branded innovations tailored to specific consumer needs is proving successful. We have stayed focused, and is shown in our Q2 results. The combination of these efforts and an industry-leading balance sheet sets us up well to grow in our current markets and execute in any new market we decide to enter.

With that, I'd like to pass it on to James to take you through our financials.

James Holm

Chief Financial Officer, Cronos Group, Inc.

Thanks, Mike. Good morning, everyone. I will now review our second quarter 2024 results in relation to the prior year period. The company reported consolidated net revenue of $27.8 million, a 46% increase from the prior year. Constant currency consolidated net revenue increased by 49% to $28.3 million. The revenue increase was primarily driven by higher cannabis flower and extract sales in Canada, higher cannabis flower sales in Israel and sales in other countries, which included Germany and the UK.

Gross profit in the second quarter was $6.3 million, equating to a 23% gross margin, representing a $3.2 million improvement in gross profit and roughly a 600-basis point improvement in gross margin. The increase was primarily driven by higher sales in cannabis flower and extracts in Canada, higher cannabis flower sales in Israel and sales in other international markets, partially offset by an adverse price mix in the Canadian cannabis flower category, driving increased excise tax payments as a percentage of revenue.

Consolidated adjusted EBITDA in the second quarter was negative $11.1 million, representing a $4.9 million improvement from the prior year period. The improvement year-over-year was driven by an increase in gross profit and decreases in sales and marketing and general and administrative expenses. It's important to note that during the quarter, we incurred a $1.2 million noncash CECL charge within our general and administrative expense line associated with the additional credit facility for GrowCo's expansion, which is not adjusted for in the adjusted EBITDA figure. This charge will reverse upon consolidation in Q3.

The strong OpEx controls employed to date have put us well on our way to achieving our 2024 goal of saving an incremental $5 million to $10 million for Cronos on a stand-alone basis. Our joint venture, GrowCo, continues to excel, demonstrating robust performance in line with our expectations. GrowCo reported to us preliminary unaudited revenue of approximately $2.7 million from third-party customers in the second quarter. Additionally, the combined credit facility that Cronos provided GrowCo, currently at $74 million outstanding following the principal repayment of $1.2 million in Q2. In addition, GrowCo made an interest payment of $1.4 million in Q2.

Mike took you through the deal rationale and high-level numbers, but let me briefly share more details on the transaction with GrowCo. Cronos has provided a second credit facility to GrowCo of approximately $51 million to fund the expansion of GrowCo's purpose-built cannabis facility. With this additional investment, the GrowCo board expands to five members, three of whom have been appointed by Cronos.

We also struck a new supply agreement that will give Cronos the option to purchase up to 70% of the total production once the expanded facility is online. In Q3 2024, Cronos will consolidate GrowCo's results in its financial statements, which we believe will highlight the significant underappreciated strength of GrowCo's performance and the advantages provide to our overall business. We are excited about the expanding partnership with our JV partners and look forward to continuing to grow with them.

Turning to the balance sheet and cash flow. The company ended the quarter with $848 million in cash and cash equivalents. Cash and cash equivalents were down by $6.9 million from Q1 driven by an $8.8 million cash from investing activities outflow for advances in loans receivable to fund the construction of GrowCo's Phase 2 expansion.

Cash flow from operations was positive $1.7 million compared to a negative $11.8 million in the prior-year period. And free cash flow was positive $8 million compared to a negative $12.3 million in the prior-year period. So a significant improvement.

Despite our cash balance being down in the quarter, you can see the underlying fundamentals of our operations are showing a significant improvement. And without the additional investment to expand GrowCo, our balance sheet would have been up sequentially by almost $2 million.

Due to the additional $51 million investment in GrowCo and resulting facility expansion, we no longer anticipate the net change in cash, defined as the sum of cash and cash equivalents and short-term investments to be positive in 2024. This additional investment to expand GrowCo's purpose-built cannabis facility will greatly aid our ability to service existing markets and take advantage of additional growth opportunities.

Looking back on the progress we have made, I share in Mike's confidence in the trajectory of our business and our preparedness for entering into new markets as they become available.

With that, I would like to hand it back to Mike for a brief comment before going into Q&A.

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

We're on the right trajectory, growing revenue, improving margins and reducing costs, all while building our borderless product portfolio, supplemented by new and exciting innovations and opening new markets globally.

With that, I will open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will conduct the question-and-answer session. [Operator Instructions] Your first question comes from Yewon Kang with Canaccord Genuity. Please go ahead.

Yewon Kang
Analyst, Canaccord Genuity Corp.

Q

Hi, good morning. Thank you for the question. Just the first one here is regarding the GrowCo investment. I wanted to see if you guys can provide some color behind the cost-benefit analysis that must have been conducted in terms of investing your dollars into Canadian-based GrowCo versus in production facilities located in international channels that you supply to given that the facility expansion in GrowCo is going to be heavily leveraged to increase your supplies into those channels? Thank you.

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

A

Sure. Good morning. So as I discussed at the beginning of the prepared remarks, we've really seen a huge shift in the supply dynamics where we've had significant oversupply in the past for high-quality flower, which we've seen GrowCo consistently produce. There really is a shortage. And I think as we see international markets expanding, we're – and we're seeing supply contract in Canada, we're seeing from both ends that gap expand and we're seeing pricing increase.

So we think that it's not just what we've been able to do with achieving number one flower brand in Canada, but also with the growth we're seeing in international markets, it's a really good way for us to continue to fuel growth. But also from a risk perspective, GrowCo already being profitable, looking and seeing, we do own 50%, now we consolidate. We think that we're able to control, we've seen for years how they perform. It's a really good way for us to do it. We've been very disciplined and conservative and see this as a great risk-reward overall.

Yewon Kang
Analyst, Canaccord Genuity Corp.

Q

Thank you. And just my second question here as a follow-up. I wanted to ask about what your plans are for PEACE NATURALS Campus going forward given that the sales leaseback that was previously announced has been terminated? And if this idle facility is causing any kind of drag on your [ph] guys' (00:17:55) operations for the past few quarters? Thank you.

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

A

Sure. Thanks. It's a great question. So PEACE NATURALS has not been idle. It's actually where we make our edibles, a number of derivative products, packaging. So it's still our center where we bring in and package flower, we ship distribution. So as we're continuing to see growth in the Canadian market, adding products, adding Lord Jones. We actually like having the ability to have space of one licensed campus that we can keep moving into. So we don't see that as a drag. We think that, especially once Phase 2 is complete, having that extra space is going to be critical to being able to achieve our objectives.

Yewon Kang
Analyst, Canaccord Genuity Corp.

Q

Thank you for the color. I'll jump back into the queue.

Operator: [Operator Instructions] I'm showing no further questions. Yewon, if you would like to continue, you may.

Yewon Kang
Analyst, Canaccord Genuity Corp.

Q

I think I'm good. Thank you so much.

Operator: Thank you. I'm showing no further questions at this time. Thank you for your participation in today's conference. This concludes the program. You may now disconnect.