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PRESENTATION

Operator

Good morning. My name is Phyllis, and I will be your conference operator today. I would like to welcome everyone to Cronos Group's 2021 Second Quarter 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.

Shayne J. Laidlaw - *Cronos Group Inc. - Director of IR & Strategy*

Thank you, Phyllis, and thank you for joining us today to review Cronos Group's 2021 second quarter financial and business performance. Today, I am joined by our President and CEO, Kurt Schmidt; our CFO, Jerry Barbato; our Executive Chairman, Mike Gorenstein; and our EVP of Legal and Regulatory affairs, Xiuming Shum.

Cronos Group issued a news release announcing these 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 Kurt, 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 these forward-looking statements, including as a result of the factors described in the cautionary statements and risk factors included in the company's earnings release and regulatory filings, including the company's most recent annual report on Form 10-K and quarterly reports 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 the 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 press room section of our website thecronosgroup.com. These non-GAAP measures may not be comparable to measures used by other issuers.

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, cross-talk or minor technical issues during this call. We thank you in advance your patience and understanding. We will now make prepared remarks, and then we will move to a question-and-answer session.

With that, I'll pass it over to Cronos Group's President and CEO, Kurt Schmidt.

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Thanks, Shayne. Good morning, everyone, and thank you for joining us today. At the beginning of this year, I noticed how critical a keen focus on building disruptive technology and innovation is to Cronos. This past quarter, we took an important step in bringing commercial-scale, cultured cannabinoids to the market as we amended our agreement with Ginkgo Bioworks in order to enable us to accelerate the commercialization of culture cannabinoids at scale.

At this stage, we have all the necessary licenses to commercialize a product using cultured cannabinoids produced in our Winnipeg facility, and we plan to be the first to market with a product that leverages this technology in Canada later this year. We'll be using cultured CBG in our first product introduced to the market, enabled by our partnership with Ginkgo, and we expect the final productivity target for CBG will be achieved in the coming weeks prior to September 2021, as previously announced.

We are making strides to ensure that Cronos become synonymous with innovation. Launching cultured rare cannabinoids is a broader long-term approach to branding and product differentiation. This will not be just a single item featuring CBG. We believe the Spinach brand is a great platform to bring these rare cannabinoids and unique formulations to our adult consumers. Cannabis holds many unique compounds with a wide range of potential use cases and benefits.

Cronos' focus on rare cannabinoids will drive significant market knowledge and consumer insights that are expected to help deliver novel and innovative products. Our cross-functional teams have been busy bringing our innovation pipeline to life by developing and commercializing new products. We take a methodical approach to product development by focusing on consumer insights, product testing and pushing ourselves to bring best-in-class products to market.

In the second quarter, our Spinach brand launched SOURZ by Spinach in Canada, an exciting new line of cannabis gummies with bold and unique dual flavor combinations. SOURZ by Spinach was developed by Cronos Group's experienced team of professional chefs, food scientists and consumer packaged goods experts. I am proud of the brand's ability to rise to the challenge of creating a cannabis edible product rooted in the principles of the confectionery category.

SOURZ delivers bold fruit flavors in a distinctive "S" shape with a proprietary coating designed to provide a sour and sweet flavor profile, differentiating the product and elevating the consumer experience. This product has an unparalleled taste for adult consumers, and early feedback on the product has been great. According to Hifyre data, SOURZ by Spinach has achieved a double-digit market share in the edibles category during the July and August-to-date period.

OCS data for Ontario sales to retailers reports that all three of the SOURZ by Spinach SKUs ranking in the top-10 of the edible category during the 4-weeks ending August 1, 2021.

Building on the strength of our Spinach gummies portfolio, we plan to leverage this brand and product format to bring cultured CBG to market. The soon to be introduced Spinach gummies utilizing cultured CBG and traditionally cultivated and extracted THC will carry the same core differentiators as our other SKUs, but with different flavor profiles. The first Spinach gummy featuring cultured CBG is planned to be pineapple starfruit flavor, and early indications from sell-in efforts are strong.

The Spinach brand also launched a new concentrate product called Spinach DABZ and a 28-gram format for Spinach flower called Spinach Nuggetz in Canada. The Spinach brand continues to extend into new categories to address consumer needs and build our presence on shelf at dispensaries across Canada. Along with these exciting launches into new categories, Spinach is shining in the dried flower category. The Spinach GMO Cookies 3.5 gram flower SKU was ranked in the top-5 SKUs for the 4 weeks ended August 1, 2021. Spending multiple weeks as the #1 SKU across all product formats according to OCS data. This is a true testament to all the hard work our cross-functional teams have put into the brand and the product, which we are now seeing paid dividends on shelf.

Turning to the U.S. market. We are excited to officially relaunch our CBD brand, PEACE+, through the direct-to-consumer channel. PEACE+'s initial portfolio of CBD tinctures are now available on peaceplus.com with many more exciting new products on the horizon. We are relaunching the PEACE+ brand because strategically, PEACE+ complements our other CBD brands nicely. And provides future distribution opportunities for us by producing a line of CBD products for mass market consumers in the United States, and giving us an offering at a mainstream price point.

We are looking forward to seeing all the additional innovation yet to come from this brand and look forward to reaching another group of adult consumers with this offering. We have so far received strong indications of interest in PEACE+ from some significant convenience store chains. And are hopeful to start shipping to regional test markets soon to complement our direct-to-consumer efforts. In July, our masstige position brand, Happy Dance, which we co-founded with actress Kristen Bell, launched a new facial skin care product, the Look Alive CBD Face Moisturizer. The moisturizer has a light texture and is packed with hydrating ingredients like avocado oil, hyaluronic acid and high-quality CBD. The product is now available online to U.S. consumers through the brand's direct-to-consumer website, doahappydance.com, and online at ulta.com. And it is anticipated to be available in ULTA Beauty stores throughout the U.S. in the coming weeks.

Continuing to build our product portfolio is critical to attracting new consumers to the brand and providing existing consumers with options and additional products so they can expand their usage occasion with our brand. In the Israeli market, the number of registered cannabis patients continues to grow, now nearing 100,000. Our PEACE NATURALS brands continues to resonate well with consumers in this rapidly growing medical cannabis market. Within the Israeli cannabis market, our dry flower products continue to perform well and recent introductions of oils and pre-rolls are gaining traction.

Turning to our people. I would now like to take a moment to discuss an addition to our Board of Directors and a few key hires, which highlights our commitment to building a winning team of seasoned and passionate professionals. During our Annual General Meeting, shareholders voted in a new Board member, Kendrick Ashton. Kendrick is the Co-Founder and Co-Chief Executive Officer of The St. James, a leading developer and operator of performance, wellness and lifestyle brands.

Before founding The St. James, he was a founding member and Managing Director of Perella Weinberg Partners, a financial services firm. Kendrick's mix of business acumen and entrepreneurial experience makes him an excellent fit for our Board. I am pleased to welcome Kendrick Ashton to the Cronos Board of Directors, and look forward to having his expertise help us as an organization.

Last month, Carlos Cortez joined the organization as VP and Controller. Carlos leads our global accounting, shared services, cost accounting and financial reporting team. Carlos comes to us with 18 years of experience, including serving as a Senior Finance Director for Discovery, Inc. Before his time at Discovery, Carlos spent five years as the Corporate Controller for Malibu Boats.

This month, we also welcomed Anthony Parisi to Cronos as the new Head of Global Audit. Anthony will lead our efforts to create world-class internal controls by developing top-tier risk management, control and governance profit. Anthony comes to us with over 18 years of audit experience. And most recently, the Vice President of Internal Audit for two NYSE-listed company, RPC, Inc. and Marine Products Corporation.

Last but certainly not least, Thomas Cohn joined Cronos as Head of Regulatory and Product, a newly formed role for Cronos. Thomas joined us from The Avon Company, where he served as General Counsel and Corporate Secretary. Thomas also spent 18 years with the Federal Trade Commission, where he was responsible for, among other things, managing any trust and consumer protection investigation and law enforcement actions. Kendrick, Carlos, Anthony and Thomas are a subset of the talent we've added across the organization. We look forward to having them and the other new additions to the team contribute to the evolution of Cronos as we work to position ourselves as a leading cannabinoid company.

As we've mentioned before, we have been actively evaluating opportunities in the U.S. cannabis market as legalization efforts and the regulatory process continues to evolve. As more and more states legalize cannabis, and there is a clear momentum of federal legalization, we want to make sure we have a seat at the table and are well positioned to capitalize on market opportunities at the appropriate time.

In June, we were pleased to announce a strategic investment in PharmaCann, which sets the foundation for our entry into the U.S. market. PharmaCann, a leading vertically integrated U.S. cannabis company has demonstrated operating expertise and is well positioned in high-value limited license states. PharmaCann's strong geographic footprint in the U.S. includes 6 production facilities and 24 dispensaries operating under the Verilife brand across 6 states: New York, Illinois, Ohio, Maryland, Pennsylvania and Massachusetts.

We are excited about our opportunity to work with PharmaCann in the future because of our shared commitment to elevating product quality and consistency through science and best-in-class operations and manufacturing. In PharmaCann, we have found an investment that checks all our criteria for what we look for in a strategic investment: market leader, unique platforms, intellectual property and branding potential. With its strategic manufacturing infrastructure, talented product development team and best-in-class operations in multiple high-growth states, we are confident in PharmaCann's potential.

Our U.S. growth strategy remains focused on delivering long-term shareholder value by assembling a portfolio of best-in-class brands and intellectual property, while simultaneously positioning to deploy our products in the U.S. market through strategic investments in U.S. leaders that share our vision and commitment to responsibly distribute disruptive cannabinoid products that improves people's lives.

Growth is also anticipated to be achieved through organic opportunities, utilizing the existing brand and IP developed in-house. Most notably, as spoken about earlier, our culture cannabinoid capabilities. We are also encouraged by the thoughtful and serious legislation brought forward by Senator Schumer, Booker and Wyden, which provides some measure of restorative justice for those individuals and communities harmed by the war on drugs. We firmly believe that policymakers and regulators must invest in approaches that support responsible adult consumption, limit harm for consumers by curtailing the illicit market. And create a legal and well-regulated federal framework for the cannabis industry in the U.S. We encourage Congress to act swiftly to pass the Cannabis Administration and Opportunity Act into law.

In addition to reporting on our business results today, we announced the appointment of Bob Madore as our next Chief Financial Officer. Bob will be officially joining the company on Monday and succeeds Jerry Barbato. Bob is a senior executive with over 30 years of financial and operational experience at a number of well-known global consumer brands. He served as CFO at American Eagle Outfitters, and prior to that, he served in a variety of roles of increasing responsibility at Ralph Lauren, including as CFO from 2015 to 2016.

He has a reputation for developing high-performing teams and achieving outstanding results. I look forward to working together as we continue to execute our strategy and accelerate our growth at Cronos. Please join me in welcoming Bob to his new role.

I also want to thank Jerry for his contributions to our company over the last two years. During Jerry's tenure with Cronos, he played an instrumental role in strengthening our finance and procurement functions, driving the SAP implementation, both in Canada and the U.S. And building out our information system and capabilities with a new focus on cybersecurity. On a personal note, he helped me tremendously as I got my feet wet at Cronos. I've enjoyed working with him, and I appreciate his partnership and wish him all the best.

Now I'll turn the call over to Jerry to say a few words on his announcement before getting into the 2021 second quarter financial results.

Jerry Filomena Barbato - Cronos Group Inc. - CFO

Thanks, Kurt, and good morning, everyone. It has been a privilege to work with the Cronos team, and I'm proud of all we have accomplished over the last several years. I know that under Bob's leadership and with support of the outstanding teams across the organization, the company is well positioned to lead the global cannabis industry and capture the significant opportunities ahead.

I will now move to a discussion of our 2021 second quarter financial results. The company reported consolidated net revenue in the second quarter of 2021 of \$15.6 million, a 58% increase in the prior year period. Revenue growth year-over-year was primarily driven by the continued growth in the adult-use Canadian cannabis market, and increased sales in the Israeli medical market.

Consolidated gross loss for the second quarter of 2021 was \$15.8 million, a \$12.9 million increase in losses from the second quarter of 2020. The increase in losses versus prior year was primarily driven by an increase in inventory write-downs in the Rest of World segment, which totaled \$12 million in the second quarter of 2021 versus \$3.1 million in the second quarter of 2020. The impact of strategic price reductions on various adult-use cannabis products in Canada taken in the second half of 2020 as well as start-up costs associated with new product development in the Rest of World segment.

Adjusted EBITDA loss for the second quarter of 2021 was \$49.8 million, representing a \$22.8 million increase in losses from the second quarter of 2020. The increase in losses year-over-year was primarily driven by an increase in gross loss, as previously explained, an increase in sales and marketing spend due to brand development in the U.S. segment and an increase in R&D, driven by spending on product development and developing cannabinoid IP in the Rest of World segment.

Turning to our reporting segments. In the Rest of World segment, we reported net revenue in the second quarter of 2021 of \$13.4 million, a 74% increase from the prior year period. Revenue growth year-over-year was primarily driven by the continued growth in the adult-use cannabis flower market in Canada and sales in the Israeli medical cannabis market.

Gross loss for the Rest of World segment for the second quarter of 2021 was \$16.4 million, a \$12.9 million increase in losses from the second quarter of 2020. The increase in losses versus prior year was primarily driven by an increase in inventory write-downs, the impact of strategic price reductions on various adult-use cannabis products in Canada taken in the second half of 2020, as well as start-up costs associated with new product development.

Adjusted EBITDA loss in the Rest of World segment for the second quarter of 2021 was \$32.6 million, representing a \$14.0 million increase in losses from the second quarter of 2020. The increase in losses was primarily driven by an increase in gross loss and an increase in R&D costs.

Turning to the U.S. segment. We reported net revenue in the second quarter of \$2.2 million and gross profit of \$0.6 million, both of which were roughly flat to the prior year period. Adjusted EBITDA loss in the U.S. segment for the second quarter of 2021 was \$10.7 million, representing a \$5.9 million increase in losses from the second quarter of 2020. The increase in losses was primarily driven by an increase in sales and marketing costs related to brand development.

Overall, Cronos Group reported an increase in net income versus the prior year period, primarily due to the change in fair value of the financial derivative liabilities associated with Altria's investment, which is described in more detail in the 10-Q.

In the second quarter of 2021, the company recorded a non-cash gain of \$115.2 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 \$1.1 billion in cash and short-term investments, which is down roughly \$142 million from the first quarter of 2021. As a reminder, as Kurt discussed during his prepared remarks, we deployed approximately \$110 million to acquire an option for a 10.5% stake in PharmaCann during the second quarter of 2021, which drove a significant portion of the sequential decrease in cash and cash equivalents.

Capital expenditures for the quarter were \$2.1 million with the spending focused across our global strategic priorities. We remain committed to deploying capital in a disciplined manner and only in ways that align with our strategic priorities. I continue to be encouraged by the work our teams are doing globally.

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

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Thank you, Jerry. Despite the ongoing challenges posed by the pandemic, our industry continues to show resilience. Against this backdrop, we continue to bring high-quality and novel products to market under our brands in the U.S., Canada, Israel and Germany. With our balance sheet, existing CBD infrastructure, our strategic investor, along with our success and insights ready to leverage from all other markets, we are confident we are well positioned to be a best-in-class cannabis company in any market we compete.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Andrew Carter with Stifel.

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

I guess I wanted to ask, and maybe I'm beating a dead horse asking about the gross margin here. It continues to be underwhelming. So I just wanted to ask what kind of signs we should see to start to see a stronger performance in this line? Is the innovation going to be margin accretive? Are you in a position on your kind of third-party cost to where that can be profitable? Or do you have the right price points? Anything you can help us on this gross margin line.

Jerry Filomena Barbato - *Cronos Group Inc. - CFO*

Thanks, Andrew. The way that we think about it, we definitely had inventory write-downs this quarter of \$12 million, and we continue to evaluate the competitive landscape in concert with consumer preferences to drive product innovation. And I think that's what really hampered our margins in the quarter. As Kurt talked about in prepared remarks, we're definitely seeing green shoots in terms of our revenue and innovations with GMO Cookies in the flower category and our SOURZ in the edibles. And obviously, the Ginkgo cannabis products that we're going to be launching later in the year.

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

Okay. Second question, switching gears a little bit. I mean the headset data we've seen has validated a very strong performance by Spinach in Ontario and Alberta, in particular. So I guess one question I have. We know it's a volatile supply chain in Canada. Are the reorders -- with the strength, are the reorders keeping up with your expectations? Are the retailers able to reorder and get it from the provinces and the provinces coming to you? Could you kind of help us out with that?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes. You're right. SOURZ is doing really well. We have 2 SKUs in the top 5, and 3 in the top 10. The early success has been very good, and we feel confident we can handle the demand. Again, we weren't first in market with the gummies. We spent some time trying to get this thing right, but the early results speak for itself as far as bringing this high-quality product. And that confidence has led us that we believe our first rare cannabinoid launch of with CBG will be under the SOURZ brand -- under the Edibles brand.

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

Yes. But my real question is I get the strength. My real question is, is the supply chain, are you really seeing the commensurate reorders? Or is it just kind of more of the same volatility like we kind of see from the supply chain?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes. Well, it's early days. But clearly, the feedback from the trade is excellent. So that's a sure indication that the reorder should be strong as we bring these consumers into the category and more of them experience. And with the marketing programs that we're doing there to educate on the product. So we feel pretty bullish because the product is delivering. I mean, we get very good feedback that the product is delivering, and that's a really good sign for repeat.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

It's Mike. Just to add to that. I think things have certainly improved in Canada as the COVID restrictions have been lifted. So a lot of the supply chain challenges that you've heard about with provinces were related to the more intense lockdowns in Canada versus the U.S.

Operator

Our next question comes from the line of Rahul Sarugasar with Raymond James.

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

A big welcome to Bob. So this is terrific news that Cronos fermentations called through CBG will be included in the Spinach gummies before the end of this year, particularly given that Ginkgo itself has been highlighting his partnership in its own upcoming public listing. So my first question is how is the Ginkgo Cronos partnership evolving towards the development of additional culture cannabinoid? And when do you expect this broadened portfolio to be -- to fungible molecules to be included in Cronos products in Canadian or potentially even U.S. shelves?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes. Again, we shifted our strategy. We talked about, in the last call, the focus on the rare cannabinoids. And you're seeing we're progressing our first one CBG with that launch coming, upcoming. So we're -- we feel very good that we're on track to deliver for these products as we go over time. So again, you've seen us saying in the way of us meeting the kind of milestone time lines we had for a launch plan. We reordered to focus on the rarer first versus the common CBD and THC.

And we are really bullish. You're going to see this coming over the next 18 to 24 months, you're going to see these products coming online. And so again, it's the strength of this joint venture and the partnership and the innovation we're spinning off. We're really, really confident. Mike, I don't know if you want to add anything on that since you've been instrumental in the Ginkgo agreement and process.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

Sure, yes. Thanks, and I think that's right. You'll see us continue to include cultured cannabinoids, specifically the rare ones. CBG, we're starting off with SOURZ, but you'll see that also spread to other formats, and we're making great progress with Ginkgo, and it'll be similar to how we're launching CBG when you start seeing some of the other rare cannabinoids added to the specific formats. And then depending on the consumer insights spread into other formats as well. So that will just be sequenced over the next couple of months and quarters.

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

Great. We'll certainly look forward to that. So now moving to the U.S. It's great to hear that the Peace+ have been relaunched. Would you be able to share any more color on how the partnership with Altria may enable penetration, particularly in the c-store channel across the U.S. and how we should be looking at that adoption ramp?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Right. So yes, we believe the addition of PEACE+ is a really nice component to a pure pricing strategy. And again, we've got 4 tincture SKUs that we're launching. We're starting on our B2C website. That will expand. We are working with c-stores and convenience stores, and we hope to announce something in the not-too-distant future on that one. As far as Altria, that is certainly value-added that we could have. Now that would require some things we've talked about before as far as getting the FDA to -- on the edible side, on the regulatory side. But as you know, as soon as there's clarity there, that leverage point of Altria we can take advantage of immediately.

Operator

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

John Zamparo - *CIBC Capital Markets, Research Division - Associate*

I wanted to start with the Spinach brand as well. It does seem like it's capturing more market share and price is certainly a part of the picture there. But has there been any other strategic shift that you can share that's helped cause that, whether it's promotions or marketing or interaction with retailers or something on the cultivation side? I just like to get a sense of what's causing that brand to move so meaningfully when most of the other large brands are fairly stagnant. And then related to that, do you think you found the right level of pricing on expenditure? Or are there more investments to be made?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes. I think it's a combination of things. Innovation is certainly a clear driver of that. We talked about that in our new flower launch, which is doing exceptionally well. And that is science behind the genetics of that plant. SOURZ, which is just a combination of fantastic, some proprietary parts of that product. But really treating it like confectionery, like Mondelez, which we launching a product. It's a fantastic product and carrier. So innovation is going to play a big part of this. Extending the brand in certain areas will play a part of it. We talked about the Nuggetz in the 28 gram and DABZ coming in there. So as we round out a portfolio.

The second part is focus. We're really focused on the Spinach brand. I'd rather have one power brand than 28 brands that are all kind of doing something. We believe the Spinach brand resonates with consumers. It's got a great brand positioning. We worked very hard on that. I think it's a lot of the blocking and tackling execution is probably the third point of that, which includes some of that marketing.

And those 3 elements I think, are really, really our strength going on in the future and will continue to be the innovation carrier for us. And that pipeline is being worked on, and it's -- we're staging that as we go along. Mike already alluded to the culture of cannabinoids where that could possibly go. So we feel this is our power brand. And I'd rather have 1 Coca-Cola than 55 different bottle water brands, right?

So we're going to really focus on that brand. And I think we're seeing that pay off, that strategy pay off.

John Zamparo - *CIBC Capital Markets, Research Division - Associate*

Okay. That's great. I appreciate the color. And then my second question is on the PharmaCann investment. Are you exploring other incremental investments of that nature? How would you characterize the attractiveness of the M&A landscape in the U.S. at the moment? And how do you think about targeting brands versus operators in cultivation or retail?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes, I'll kick off, and then I'll let Mike jump in because he's really been leading us in this venture. First of all, we think PharmaCann is a great one. We have a set of criteria. We look at what we would want to be part of and PharmaCann, I mean, really checked all the boxes for us. So it's a fantastic strategy. They're a best-in-class operator. We've talked about before this I-80 strategy they have and limited license states from Illinois to Massachusetts. We think they have capacity to grow, organically and through M&A. So it really kind of checked all those boxes. But we've been pretty consistent saying we're not finished.

We look at -- our criteria is breadth, geographic beachhead items, but brands is also very important. So it's not out of the realms of possibility that we may focus on something else that brings a different set to the party. But I will tell you, we look at it, it has to be complementary to the overall strategy. Mike, you should probably weigh in on this a little bit.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

Sure. And thanks, John. I think the M&A landscape certainly is attractive. One of the things that's, I think, being focused on by a lot of potential targets is and really was amplified by the language in the Schumer bill around interstate commerce is what benefits there could be from a potential partnership and how things may change once things are federally legal. And that really aligns with the way that we're looking at them. So brands are certainly going to be important. We think, ultimately, that's where the value shifts long term.

We understand there's a balance between where value shifts long-term within brands and sort of over the medium term, how you build those brands and get them out. So I would say that there could be similar structures. We have other structures that we've looked at. But we're still very, very excited, and we think there's a lot of attractive opportunities that will fit very well for us in the U.S.

Operator

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

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

On the U.S., I was hoping we could dive in a little bit on CBD. I was hoping to get your most current assessment of the market from a sizing perspective. And then specifically, on Happy Dance, if you could comment on any intra-quarter trends and whether you're seeing at all a recovery or an uplift as consumers get back and they can even go back into stores?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes, I'll kick it off and then let Jerry or Mike comment. We're starting to see -- we had a lot of hopes of COVID recovery. But as you know, lately, we seem to be going back into this COVID delta thing. So we don't know how that one is going to swing out. We were hopeful because you do see bricks and mortars coming back, but we need to see that infinite. I have to say, we're -- overall, we're not happy with the results in the U.S. CBD market. We don't break down our performance by brand.

But we are taking a strategic review of the brands. We've got some good things, but certainly, I'm not happy. I'd like to see faster growth. And so we're kind of reviewing everything on this one. That includes the portfolio, price gap, price management, what we're doing there, product offerings, and we're looking at the marketing mix. We don't have the full results yet. We're getting -- we're trying to complete that, but we have a couple -- we have 2 markets that we've been testing, advertising in a more aggressive marketing mix on the product.

Now that looks encouraging, but we have to see how that ends up. But we need to review everything and make sure that we can get the pace because, generally speaking, we were not happy with the results this quarter. But again, some of that is related to the COVID. Some of it's related to some changes in some of the DTC capability, especially with Apple's new security has been -- has certainly had an impact. But again, we believe we get the elements right and we get the investment right. The brand resonates very well with consumers that we'll get it back to the trajectory we want.

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

Okay, perfect. Just sticking with the U.S., my follow-up question, please, on PharmaCann. Can you comment at all around any opportunities around IP or trademark exchanges or sharing?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes. I'll let Mike weigh in on this because it's good to have him. He's also the lawyer in the room with me. Yes, we're looking at those types of things, but all those have to be managed under the guise of -- a path of investment and the lack of federal legalization. But certainly, if you look at the announcement we made, there's tremendous opportunity once federal legalization comes. But that doesn't mean we're thinking about what happens if prior to federal legalization, a bunch of things happen.

I just can't commit to anything because we have that restriction of ensuring that we can do this and do this in a way that is sensible for us and the guys of the regulatory environment. Mike, I don't know if you want to add anything to that.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

Yes, sure. Vivien, we certainly see this as something that's very strategic for us as far as pushing brands out. I think the way that we really focused on getting that advantage was in setting up distribution agreements that we can sort of trigger at our own option. So we're going to continue monitoring and making sure that whatever it is that we do to get our brands out is done in a way that wouldn't, in our view, affect anything with the CSA. But we feel that there's a strong partnership that we can use to leverage brands. Too early to speak about any imminent trademark swaps, though.

Operator

Your next question comes from the line of Tamy Chen with BMO Capital Markets.

Tamy Chen - *BMO Capital Markets Equity Research - Analyst*

First question is on the vape category. I recall processes maybe about 2 years ago. You talked about your initial launch of vape products in the Canadian market would be sort of first-gen. But that you'd be working on next-gen proprietary products in this category. So I just wanted to see if I get an update on how that's going with respect to the innovation work for the vape category in particular.

Kurt Thomas Schmidt - Cronos Group Inc. - President & CEO

Yes, this is Kirk. Thanks for that question. Yes, we are working on it, and you're going to see something in the not-too-distant future. But I don't want to talk about the actual dates or anything on innovation. But we are working in that -- on the vape segment right now.

Tamy Chen - BMO Capital Markets Equity Research - Analyst

Okay. Got it. And then my follow-up is going back to the first culture CBG product under the SOURZ format in Canada later this year. I was wondering if you could talk a bit on how you're going to position the product. I presume, like from a marketing perspective and making sure that staff in stores are educated on that, on the differentiation that they can communicate it to consumers because with respect to product launches in general in Canada. And I recognize this is a unique product, but it is a very crowded market. There's a lot of different products and brands on shelves. To what degree of confidence do you have that there's going to be strong uptake for a CBG product in particular? And what sort of work you're doing to ensure getting the shelf space it's going to get the budtender attention and positioning?

Kurt Thomas Schmidt - Cronos Group Inc. - President & CEO

Yes. Good question. Well, we have a full team from developers innovation to the research we've done to the product developers, to the marketing teams. We don't view this as a product. We view this as a concept, a business concept. And we think we have something really interesting, a sub-brand under the Spinach line. And we believe that's the way to do it. That's my background. Blue Buffalo built a \$1 billion business on a single brand called Blue Buffalo, but we had life protection. We had wilderness. We had Freedom sub-brand on Blue Buffalo, and we had basics there.

And we believe this concept -- and we spent a lot of working on how to communicate with consumers. So obviously, we're rolling out. We have to get to each one of these rare cannabinoids. So it takes time. You can't make all 6 at once. But we are not thinking about this as a product. This is not a product. This is a brand concept, lifestyle, positioned against consumers, resonating with consumers. And that's the way we look at this thing. And we're confident we're on the road to creating that. And we think that's really what this whole thing is about.

Michael Ryan Gorenstein - Cronos Group Inc. - Executive Chairman

And Tamy, just to add, I think if you think about edibles as a crowded space, even without rare cannabinoids, which is where we've seen a lot of excitement from retailers and from the provincial boards. We launched Spinach SOURZ and immediately had great success, and we saw that as a pre-seeded launch of the rare cannabinoid edible. So we've had great success without them, and we expect that's only going to be stronger once we have the key differentiator added to those.

Kurt Thomas Schmidt - Cronos Group Inc. - President & CEO

And again, as Mike said, we're going to grow the business. Edible is a great start for us, but other 2.0 products are great vehicles for this. And so we've got innovation along the concept. We've got innovation along where we can move the brand to the products, too. So it's an exciting -- I think, like I said, there's been a hell of a lot of work done by the teams. And I think we've got it. And I'm looking forward to -- you'll start to see a little bit of that when we launch the first one here in September.

Operator

Our next question comes from the line of Heather Balsky with Bank of America.

Heather Nicole Balsky - *BofA Securities, Research Division - VP*

I'm just curious, just going back to one of the questions at the beginning of the Q&A around gross margins. What do you think needs to happen? What sort of scale, what other, I guess, mix shift maybe that you need to get back to positive gross margin?

Jerry Filomena Barbato - *Cronos Group Inc. - CFO*

Yes. Thanks for that question, Heather. I think in the U.S. segment, it's really about driving that revenue growth. Our revenue was down a little bit this quarter. And I think with increased revenue, that will improve the margin in that segment. On the Canada side, we are seeing some positive momentum on the Spinach brand. And like I said earlier, our margins were negatively impacted this quarter, mainly due to the continued development of innovative products. So we have some heightened start-up costs within our manufacturing facility.

In addition, we're lapping the price reductions that we took in the Canadian market in the second half of 2020, which is causing a portion of the impact on a year-over-year basis.

Operator

Your next question comes from the line of Bill Kirk with MKM.

William Joseph Kirk - *MKM Partners LLC, Research Division - Executive Director*

I want to go back to innovation, but tackle it a bit more philosophically. It seems the pace has accelerated rather dramatically. So what philosophically for you has led to the strategic shift to focus what seems like more urgently on recreational use innovation?

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Well, thanks for the question. I don't think it's really been a shift. I mean, we work on innovation, and we come from a very disciplined, ensuring we have a distinct point of difference. And sometimes that takes longer. I think edible is a classic example. We could have thrown anything out the door. But we looked at from the consumer side, from kind of the product build side of what -- kind of what we're trying to do. And some of that takes longer. In the case that we've cultured cannabinoids, that's a pretty hefty project. That's like new science.

It's -- when I sit in the Ginkgo meetings, and I am a undergrad in chemistry. Sometimes I need the Head of Innovation to give me kind of a tutoring afterwards on some of the stuff. So we're doing some basic technologies. We want bigger ideas. They tend to take longer. On the other hand, once you get the system in place, you could start to move faster. Once you get the fundamental building blocks in place between marketing, the product development teams and the research side, you start to go and a lot of that was built.

So I think we're at the point now where we've got the right machinery and people to get this done. But we believe, again, we believe the key for us is to become a branded player and a branded player who's bringing great products that delights the consumers, and platforms that are new and unique. And so that's what we're about. And we will not lose that focus on innovation. And I think that's really critical to us as a company.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

Yes. Bill, I think you're seeing us quite a bit of work that it's not us with the urgency on product development. We just now have quite a bit of products we've developed and being very mindful about how we launch them. But having a supply chain in place. And now with retail opening back up in Canada, we think it's a good time.

Operator

Our next question comes from the line of Howard Penney with Hedgeye.

Howard Wells Penney - *Hedgeye Risk Management LLC - MD & Sector Head of Restaurants*

I was wondering if you could expand on the PharmaCann investment, in particular, the commercialization and distribution agreement that you signed and why that's important as you look to enter the U.S.

Kurt Thomas Schmidt - *Cronos Group Inc. - President & CEO*

Yes, I'll kick it off and then Mike can jump in. Yes, we're in it for the long haul. We're not -- this is not an investment for us. We're trying to build a partnership and a partnership -- so that concludes a bunch of things, and access for our brands and distribution. And access for -- eventually for our technologies. We have a great -- and I'll tell you personally, I love the guys there. We've got a great relationship with PharmaCann. We really see eye-to-eye on it.

And we're really trying to build for the long-term for what -- can we build a leading cannabis company in the U.S. So all those things, we want to mutually share what we do really well, what they have, so that we really get -- we really try to drive this thing. And so that's why the -- some of these commercial terms and distribution terms are so important for us. Again, we'd love to move faster, but obviously, because of the regulatory environment, we have to move at a different pace on some things.

But we want a commitment because we see this -- even though we only have 10%, we didn't get into this as an investment. We got into it as a long-term partnership. That's going to help drive both our businesses. Mike, I don't know if you want to add anything to that.

Michael Ryan Gorenstein - *Cronos Group Inc. - Executive Chairman*

Thanks. Yes, I think that's right. We see 2 drivers of value here. One is we think they have a great core business. And so we like the investment just purely on an investment basis, but the other is, it's really important depending on how the regulatory environment shapes up and how things progress that we do in these key restrictive markets as far as retail. Like New York, for example, there's currently 10 licenses, just knowing that we have a trusted partner with a close relationship to be able to launch our disruptive products through.

It's something that really excites us now to just to keep investing behind innovation, knowing that we'll be able to reach consumers right when we need to.

Operator

At this time, there are no further questions. Ladies and gentlemen, this does conclude today's conference call. We thank you for participating. You may now disconnect.

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