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CRON - Q4 2018 Cronos Group Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Michelle, and I'll be your conference operator today. I would like to welcome everyone to Cronos Group's Fourth Quarter and Full Year 2018 Earnings Conference Call. Today's call is being recorded.

At this time, I would like to turn the call over to Anna Shlimak, Investor Relations. Please go ahead.

Anna Shlimak - *Cronos Group Inc. - Head of IR & Communications*

Thank you, Michelle, and thank you for joining us today to review Cronos Group's fourth quarter and full year 2018 financial and business performance. I'm joined by our Chairman, President and CEO, Mike Gorenstein; and our CFO, William Hilson.

Earlier this morning, Cronos Group issued a news release announcing our financial results, which are filed in our SEDAR and EDGAR 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. Management can get no assurance that any forward-looking statement will prove to be correct.

Forward-looking statements during this call speak only as of the original date of this call, and we undertake no obligation to update or revise any of these statements, except as required by applicable law. Management refers you to the cautionary statement and risk factors included in the company's most recent MD&A and annual information form by which any forward-looking statements made during this call are qualified in their entirety.

We will now make prepared remarks, and then we'll move to a question-and-answer session.

With that, I'll turn the call over to Mike.

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

Thank you, Anna, and good morning, everyone. During my remarks today, I'd like to do a year-end review. I think it's important to look back and reflect on all that we accomplished in just 1 year as both our company and the industry moved at such a fast pace.

2018 was a highly productive year for Cronos Group with many notable company and industry milestones achieved. The past year saw the legalization of cannabis for adult use, making Canada the first G7 country to legalize adult-use cannabis nationally. We are proud to be a participant in this emerging market.

As I mentioned before, the Canadian government's leadership in implementing a federal legal framework is the reason we chose to operate in Canada. When we set out on this journey 3 years ago, we knew the value of operating in a legal environment would allow us to learn, build and create a company that has the potential to be a global industry leader. We take pride in leading the industry forward responsibly and are motivated to create meaningful products that excite our consumers and bring happiness and an improved quality of life.

The growth opportunities in the cannabis industry are vast. With our differentiated brands, global footprint, growing production capacity and supply chain, commitment to cannabinoid innovation and the strategic investment from Altria Group, Cronos Group is well positioned to realize these opportunities.

To set the stage for our earnings call today, I want to briefly review the 4 aspects of our strategy.

At Cronos Group, we are establishing an efficient global production footprint and supply chain, developing a diversified global sales and distributional network. We are creating and monetizing disruptive intellectual property and growing a portfolio of iconic brands that resonate with consumers. During this call, we'll discuss each of these strategic pillars and will provide an update on what we are going to do to grow our business globally.

I'll start with our production expansion.

In August 2018, Peace Naturals, our center of excellence, received authorization from Health Canada to cultivate cannabis in an additional building, Building 4. This 286,000 square foot facility is GMP-certified and is ramping its production of cannabis. The facility produced its first harvest in December 2018, and we still expect all flower rooms to be populated in the first half of 2019. The cultivation in Building 4 runs under a perpetual harvest cycle, similar to a manufacturing facility. Like other large-scale agriculture facilities, we expect that with each cycle, our yields will continue to improve as we dial in controls. We're very proud of this facility, our Peace Naturals campus as a whole and what we were able to build in such a short period of time.

While yields and cost per gram have been the standard unit cost metrics for the cannabis industry to date, we think this is starting to evolve. We still think that COGS will be an important measuring stick, but by that, I mean cost of goods sold, not cost of grams sold. Efficiency in downstream processing and packaging in categories such as pre-rolls will be a differentiator and an area we will increasingly focus on. And as the value-added products come online, the relevant cannabis costs will shift from grams of cannabis flower to milligrams of cannabinoid. And we've already seen the shift begin in the proposed excise tax regulations in Canada from weight of dried flower to active ingredient. With this shift in mind, we will continue working to optimize our supply chain towards final products.

As supply catches up to demand, we believe that having experienced large-scale agricultural expertise and labor management practices will be extremely important. This is why our approach to further scaling out capacity involves taking our genetics, growing methodologies and best practices that we developed at Peace Naturals, our center of excellence, and then creating co-manufacturing relationships with sophisticated agricultural operators around the world. We are confident and committed to our cultivation partnerships.

In Canada, we launched a joint venture, Cronos GrowCo, with a group of investors led by Bert Mucci, a leading Canadian large-scale greenhouse operator. As discussed during our previous earnings call, Cronos GrowCo is constructing an 850,000 square foot, purpose-built greenhouse which is expected to produce up to 70,000 kilos of cannabis annually. Construction of the greenhouse has begun, and we expect to complete the superstructure of the greenhouse in the second half of 2019. And similar to how we're bringing Building 4 online, we expect this greenhouse to become operational in stages in 2020.

We are also making progress on our international production footprint. First, turning to our joint venture, Cronos Israel, with the Israeli agricultural collective, Kibbutz Gan Shmuel.

Cronos Israel is focused on the production, manufacture and distribution of medical cannabis and is in full construction. We anticipate the construction of the 45,000 square foot greenhouse will be complete in the first half of 2019, and construction of the manufacturing facility will be complete in the second half of 2019. Cronos holds an effective 90% economic equity ownership across the entities in Cronos Israel.

In January 2019, the Israeli government approved the export of medical cannabis from Israel, which will allow license holders to export to countries that have explicitly approved the import of medical cannabis. We intend to pursue the licensing for and export of medical cannabis products from Cronos Israel to our European and global distribution partners once production operations are up and running.

In 2018, we also brought our production model to Latin America. Cronos announced a JV with a leading Colombian agricultural services provider with over 30 years of research and expertise managing industrial-scale horticultural operations. This partnership established a newly formed entity, NatuEra, in Colombia that will develop, cultivate, manufacture and export cannabis-based medical and consumer products for the Latin American and global markets. NatuEra was granted a license to cultivate non-psychoactive cannabis plants to produce seeds for planting and the manufacture of derivative products.

We understand that many investors are modeling cannabis companies off of capacity. However, our business model is not to be the former. We think that there will be value created across many verticals in the cannabis industry value chain, including cultivation and wholesale supply, research and development, branded products manufacturing, marketing and retail. We see tremendous opportunity across the whole industry but recognize that we can't be all things to all people. Rather, we will focus on areas where we see long-term, sustainable value like developing and marketing innovative branded products, and then work with experts in the other verticals. This focused approach has proven successful in analogous industries, such as consumer packaged goods in pharmaceuticals, and we think it will prove successful in the cannabis industry as well. In other words, you can expect our focus to be on making the cheese rather than raising and milking the cows.

Moving on to distribution.

Canada became the first G7 country to legalize cannabis sales for adult use. Cronos participated in the launch of this new market through our 2 adult-use brands: COVE and Spinach. Currently, these brands are distributed in Ontario, British Columbia, Nova Scotia, Prince Edward Island and Saskatchewan. As our production capacity grows, we intend to expand distribution into additional Canadian provinces and territories.

In 2018, we also announced a joint venture with MedMen Enterprises to create MedMen Canada. The private retail landscape is evolving and changing, so we continue to review and analyze the situation as it develops in each province. We think this is a valuable relationship with a large, recognizable brand.

Additionally this year, we announced that Cronos GrowCo entered into a new supply agreement with Cura Cannabis. Cura signed a 5-year take-or-pay supply agreement to purchase a minimum of 20,000 kilos of cannabis annually from the date it receives its licenses. We believe partnering with companies like Cura and MedMen set Cronos Group up for strong relationships as new and large markets open and regulations evolve.

Internationally, Cronos Group made strides in 2018 to expand its global reach with a distribution agreement to supply the medical market in Poland. In June 2018, we entered into a 5-year exclusive distribution partnership with Delfarma, a pharmaceutical wholesaler with a distribution network of over 5,000 pharmacies and more than 200 hospitals, to supply its Peace Naturals-branded cannabis products. We also have a 5-year exclusive distribution agreement with Pohl-Boskamp, an international European pharmaceutical manufacturer and distributor, for the German market, which was signed in 2017.

We see Europe and Asia Pacific to be extremely important markets for the future. But in the near term, it is our belief that the development of pharmaceutical form factors and delivery systems for medical cannabis will play a crucial role in growing the prescription and patient base in these markets. We are in the process of pursuing regulatory pathways for additional noncombustible products with our partners at Pohl-Boskamp who have expertise in the registration of new drugs in Germany.

We take a calculated approach in committing our current supply as we want to ensure we support our direct-to-patient clients, our provincial and private retail partners, our international partners and the end consumers in all these markets. As new distribution channels open, we must balance supporting our existing global footprint and meeting the demand of a newly created channel. At this stage of our business, we are very cognizant of the delicate balance while our supply ramps to meet the growing demand of our global distribution.

On the last earnings call, we spent a lot of time discussing the intellectual property pillar of our strategy. As our business and company evolves, this pillar will continue to be incredibly important in creating and driving value for our business. I want to reiterate the strategy.

We are dedicated to creating, monetizing and building a moat around disruptive intellectual property. At Cronos Group, we seek to build the world's most innovative cannabinoid company where we develop and research efficient processes to effectively produce and formulate the full spectrum of cannabinoids, not just THC and CBD. We're using the plant as a blueprint in order to learn and then create differentiated active ingredients by reconstituting cannabinoids and terpene in combinations that have specific psychoactive effects and/or therapeutic benefits. We'll then formulate those active ingredients to optimize bioavailability and customize them for the appropriate delivery systems depending on the product, its effect, use case and its commercialization pathway.

One of the ways we will accomplish this goal is through our strategic partnership with Ginkgo Bioworks, which we announced in early September. We believe this landmark R&D partnership has the potential to disrupt the industry. For the benefit of new followers to the Cronos story, I'd like to briefly explain the significance of this announcement and the power of partnering with an unparalleled company like Ginkgo.

Our objective with Ginkgo is to produce cultured cannabinoids at commercial scale. This not only includes THC and CBD but also rare cannabinoids that are economically impractical or near impossible to produce at high purity and scale through traditional cultivation and extraction. And going back to our strategy, we at Cronos believe that rare cannabinoids are key to product differentiation but today are nearly impossible to produce commercially. By using fermentation, Cronos and Ginkgo could materially reduce the cost of cannabinoid production at commercial scale and enable the production of rare cannabinoids. Using this production methodology, we can leverage existing fermentation infrastructure rather than incurring heavy CapEx to build and manage new cultivation and extraction facilities. Additionally, we believe this technology will make it easier for us to deliver product consistency. The partnership is currently focused on 8 cannabinoids. Ginkgo will design microorganisms which we can produce these cannabinoids at scale using fermentation.

The partnership is aligned to incentivize each party. Cronos common shares will be issued to Ginkgo when each of the 8 cannabinoids can be produced for less than USD 1,000 per kilo of pure cannabinoid at a scale of greater than 200 liters. In total, 14.7 million shares will be issued in tranches based on each cannabinoid. In addition, Cronos will fund R&D and foundry expenses, which are expected to be approximately USD 22 million over the term of the partnership.

In November 2018, Ginkgo received the relevant licenses to conduct cannabinoid research from the DEA and also from Massachusetts Department of Public Health. We think it will take up to September 2021, 3 years from the time the deal was announced in September 2018, to reach the equity milestones for the target cannabinoids. Upon reaching these milestones, Cronos will have the exclusive right to use and commercialize the key patented intellectual property related to the production of the target cannabinoids perpetually and globally. We know that flower and pre-rolls will continue to be desirable and significant consumer products, and we believe the production of derivative products will be achieved using cultured cannabinoids.

In the fourth quarter, we also have entered into a sponsored research agreement with Technion Research and Development Foundation to explore the use of cannabinoids and their role in regulating skin health and skin disorders. The preclinical studies will be constructed by Technion over a 3-year period and will focus on 3 skin conditions: acne, psoriasis and wound healing. The research will be led by Technion faculty members, Dr. Dedi Meiri and Dr. Yaron Fuchs, 2 of the world's leading researchers in cannabis and skin stem cell research. Dr. Meiri heads the Laboratory of

Cannabis and Cancer Research with vast experience in cannabis and endocannabinoid research. Dr. Fuchs heads the Laboratory of Stem Cell Biology and Regenerative Medicine with years of experience in biology of the skin and its pathologies.

Whether the research and development leads to products that consumers will need a prescription to buy, an adult ID to purchase or can be bought anywhere, being able to educate consumers on the advantages of our differentiated products will be very important. And that's where our brands come in. To that end, I'd like to talk about our adult-use brands.

We are focused on providing consumers with premium, high-quality products, whether it's flower or oil, which are available in the market today or in the future through our derivative product offerings. We launched 2 consumer brands in the Canadian adult-use market in October 2018. Our brand, COVE, is focused on the premium consumer; and Spinach, a lighthearted, playful brand, is geared towards the mainstream market. Our brands are tailored to offer authentic experiences for their respective consumer targets. As the product offering in Canada begins to advance with the pending regulatory changes, we believe there will be greater ability to differentiate brands through derivative products which will create a more uniquely tailored experience for consumers.

Our focus in 2018 on establishing an efficient global production footprint, developing our global sales and distribution network, creating disruptive intellectual property and growing our family of brands has ultimately led to securing major strategic partner and investor in Altria Group.

To cap off the year, we announced that we entered into a subscription agreement with Altria. Our deal with Altria closed on March 8. Altria's $2.4 billion equity investment in the Cronos Group is a major milestone for our company and a relationship we are incredibly proud to be embarking on.

Altria's investment represents an approximate 45% ownership interest in Cronos Group, and they have also a warrant to acquire an additional 10% ownership, which will provide Cronos Group with approximately CAD 1.4 billion of additional proceeds. The warrant is exercisable over the next 4 years. We expect this investment to lead to significant growth and value creation for our company. The investment not only provides additional access to financial resources but also the ability to accelerate and scale our product development and commercialization capabilities globally.

With the closing of the investment, our Board of Directors expanded from 5 to 7 members. The board now includes 3 existing directors: Jim Rudyk, CFO of Roots, who will serve as the lead director; and Jason Adler, Co-Founder and Managing Partner of Gotham Green Partners; and myself as Chairman. Additionally, we welcome 4 new directors: K.C. Crosthwaite Jr., Chief Strategy and Growth Officer of Altria; Bronwen Evan, an independent consultant; Murray Garnick, General Counsel of Altria; and Bruce Gates, former SVP of External Affairs at Altria.

Earlier this month, we also announced an expansion of our management team. Jerry Barbato, most recently Senior Director of Corporate Strategy at Altria, will join Cronos Group on April 15. Jerry will assume the CFO role from Billy Hilson. In addition to benefiting from Jerry's 20 years of experience in strategic planning, financial analysis and brand management, we expect his firsthand knowledge of Altria will help ensure that we fully capitalize on our partnership with them. And Billy will move to a new role as Cronos Group's Chief Commercial Officer and will be responsible for further enhancing the commercial strategy as well as the research initiatives of the company. Many of you may not know this, but Billy is, first and foremost, a scientist. He has a Bachelor of Science in molecular genetics and a Master of Science in biochemistry and over 15 years of experience with multinational pharmaceutical companies. As our company and business develop from cultivation to formulation, we expect Billy's scientific and pharmaceutical knowledge and relationships in those fields to further enhance the commercial strategy and R&D initiatives for the company.

These appointments demonstrate our commitment to a premier leadership team with the skills and experience necessary to support our next phase of growth and development.

As we work to transform what was once just an idea into reality, we'd like to thank our partners and shareholders for their support. It was an incredible 2018 filled with many accomplishments, many industry and company firsts, and I can already say that this year is off to a similar start. We ended the year with an ideal partner in Altria, and we look forward to the many opportunities we expect this relationship and Cronos Group to create in the year to come.

With that, I'll turn it over to Billy to give his last official discussion of this quarter's and full 2018 financial results as CFO, although I'm sure he'll be making guest appearances on these calls in the future to explain the commercial significance of some of the interesting innovations in our pipeline.

William Hilson - *Cronos Group Inc. - CFO*

Thanks, Mike, and good morning, everyone. The figures I'm reviewing today can be found in our financial statements.

We continued to see revenue growth in the fourth quarter ended December 31, 2018. The company reported net revenue of $5.6 million versus $1.6 million in the same quarter in fiscal 2017, representing a 248% increase. Revenue increased 49% quarter-over-quarter. This increase was due to shipments into the Canadian adult-use market, including strong sales of the pre-roll format, which represented 14% of net revenue in the fourth quarter, and growth in cannabis oil revenues, which represented approximately 24% of net revenue in the fourth quarter.

For full year 2018, the company reported net revenues of $15.7 million as compared to $4.1 million for full year 2017, representing a 285% increase.

Kilograms of cannabis sold increased 198% from 349 kilograms in the fourth quarter of 2017 to 1,040 kilograms in the fourth of quarter of 2018. Quarter-over-quarter kilograms sold increased by 102%. The increase was due to the growth in cannabis production. As we look to 2019, we see that quarter-over-quarter increases will slowly scale in the first half of the year as we ramp up production, with momentum for revenue growth building in the second half of the year.

Average selling price for the fourth quarter 2018 was $5.39 versus $4.62 the previous year.

On a full year basis, the average selling price was $5.74 for 2018 versus $6.43 for the full year 2017. The decrease on a full year basis is due to the impact of the excise tax that came into force in October 2018.

As we discussed last quarter, we believe gross profit before fair value adjustments provides useful information to understand and evaluate operating performance by excluding the noncash fair value adjustments associated with biological assets and inventories sold.

For Q4 2018, the gross profit before fair value adjustments of $2.5 million as compared to $0.4 million for Q4 2017 represents a 449% increase. The increase in gross profit before fair value adjustments was largely driven by an increase in kilograms sold over the comparable period prior year.

Gross margins before fair value adjustments was 44% in the fourth quarter of 2018.

During Q4 2017, the company reviewed and updated its estimates and cost drivers and allocations, including the evolution of the biological assets model, resulting in higher production and processing costs and a corresponding lower gross margin of 28% for that discrete quarter as these changes were not annualized across 2017.

Cost of sales before fair value adjustments per gram of fully loaded unit COGS decreased by 13% from $3.21 from full year 2017 to $2.80 for full year 2018. Additionally, unit COGS decreased 8% quarter-over-quarter with fourth quarter unit COGS of $3.02 compared to $3.28 in the third quarter of 2018.

Operating expenses for the fourth quarter, including salaries and benefits of non-production staff, stock-based compensation, general and administrative, sales and marketing, R&D and depreciation expenses, totaled $12.4 million, representing an increase of $9.5 million compared to the same period last year. The increase in operating expenses was driven by an increase in research and development expenses, talent acquisition and an increase in professional and consulting fees for services rendered in connection with our various strategic initiatives, including the Altria investment.

For full year 2018, the company reported total operating expenses of $29.4 million as compared to $9.3 million for the full year 2017, representing an increase of $20 million.

The company reported an adjusted EBITDA loss of $7.9 million in the fourth quarter of 2018 as compared to a loss of $1.5 million in the same quarter in fiscal 2017. Adjusted EBITDA for full year 2018 was a loss of $14.6 million compared to a loss of $4.4 million for full year 2017.

As regulations evolve and the rules of engagement change in the markets that we operate in, so do the drivers of our business. Overall, average selling prices are decreasing due to a shift in net revenue mix from the medical direct-to-patient market to the adult-use market where we wholesale to provincial governments and absorb the excise tax in both channels. On the other hand, our COGS are improving as we bring new facilities online and increase efficiencies. Our operating expenses are increasing due to the acquisition of new talent and as we begin to increase spend in a significant way in areas that drive long-term, sustainable value such as R&D and marketing. We will continue to invest in our business and are committed to doing so in the future.

Turning to the balance sheet.

As of December 31, total cash position amounted to $32.6 million. Subsequent to December 31, 2018, Cronos Group's cash position improved with the closing of the $2.4 billion Altria investment in March 2019.

In addition to providing us meaningful liquidity, the Altria investment also affords us the flexibility to capitalize on opportunistic external growth opportunities and accelerate organic growth initiatives.

I would like to provide some insights into the short-term use of funds received from Altria in March.

As we continue to scale the business for future success, we will increase our capital investments related to production specifically as it relates to our Peace Naturals facility expansion and automation equipment, GrowCo and Israel facilities.

As you are aware, the pending regulations related to the legalization of derivative products includes vaporizers and edibles in the Canadian adult-use market will require increased investment as we work our way through 2019.

And finally, turning to cash flows.

For the full year 2018, the company used $9.7 million of cash in operating activities as compared to $5.5 million in fiscal 2017, representing an increase of $4.2 million in cash used.

During the full year 2018, the company used 125.5 -- $121.5 million of cash in investing activities, primarily $114.4 million in capital expenditures to fund expansion efforts at Cronos Israel and Peace Naturals, mainly Building 4 and the Peace Naturals greenhouse, and due to $6.9 million in advances to our Cronos Australia, Cronos GrowCo and MedMen Canada joint ventures.

During fiscal 2018, cash provided by financing activities was $154.6 million primarily due to $136.5 million in net proceeds from the January 2018 bought deal and the April 2018 bought deal and due to the $15 million in debt advances. Subsequent to year-end, the company repaid all of its outstanding debt obligations in full with a portion of the proceeds from the Altria investment.

This concludes my review of the financials for the quarter ended December 31, 2018, and full year 2018.

I'd like to end the call by welcoming Jerry to the team. We are expanding our management team by adding a tremendous resource. And as much I will miss these earning calls, I'm really looking forward to my new role. As the company evolves and we move from one phase of growth and development to the next, we understand that building our intellectual property strategic pillar will require the deployment of R&D resources and the alignment of science and business to find and execute the best commercialization pathway for our products. This intersection is not only a great opportunity for me but a very exciting next chapter for Cronos Group.

Thank you, everyone, and now let's open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Tamy Chen of BMO Capital Markets.

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

I just had a housekeeping question first. Are you able to disclose the breakdown of your volumes sold between rec, Canada medical and any international export?

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

Thanks. When we look at how we plan on disclosing, I think there's a few things to keep in mind. I'd say first, we're still in a situation where we're trying to manage how we allocate between medical patients, provinces, private retail partners and international partners in a pretty big shortage situation, but we do look in the future as we think it becomes more material to break out in channels. But I think we're going to keep it as it's disclosed for now.

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

Okay. And my next question is on your pricing, I know you disclosed the average price which would have both rec and medical. But particularly on the rec side, could you provide some more color on the pricing dynamics? Because I would have thought maybe the -- your indoor products or -- and its premium position, particularly the COVE brand. I would thought there would be -- are you getting premium pricing in the rec market in Canada at this point?

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

Sure. It's a great question, and I think this goes back to what I was sort of talking about in the prepared remarks about how we're breaking down unit pricing versus using the weight. So I think what you're seeing is most reflective of a breakdown between oil and flower. And when we think of the market we're in today and the current excise tax regime, you're essentially incentivized not to sell as much oil because the excise tax, depending on the input that you use, can be, I'd say, quite punitive. So I think that we are still positioned in the premium space, but you're seeing a much bigger skew towards flower than you are towards oil.

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

Okay, got it. And if I could just squeeze in one more. I'm just wondering, you haven't made much public announcements or thinking about the whole U.S. hemp CBD market. Is this an area you're actively considering? And how are you assessing this market and trying to position the company to enter this opportunity potentially?

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

Look, our original strategy and vision for Cronos was to come up to Canada, develop a turnkey solution that we could ultimately bring down the U.S. once federally legal, and that really hasn't changed. I think relationships certainly matter in the cannabis industry, and we feel that we've done a great job of building strong relationships, both with U.S. cannabis industry stakeholders and with other strategic partners sort of along the value chain, whether that's in cultivation of other regulated crops, general retail distribution. But ultimately, we think the Farm Bill is a great step for the industry. It's going to create a lot of opportunities and really encourage the regulators and lawmakers at all levels that are prioritizing CBD in an effort to provide clarity and opportunities to industry stakeholders like us. I think that it's something that we're going to continue watching very closely. And we probably won't telegraph our strategy sort of as publicly as some others have, but we are absolutely excited about the opportunity.

Operator

Our next question comes from Matt Bottomley of Canaccord Genuity.

Matt Bottomley - *Canaccord Genuity Limited, Research Division - Analyst*

Just wanted to go back to the quarter. Just a couple of quick questions there, just housekeeping items, just to make sure I understand directionally where things are going. You mentioned quickly the oil pricing and some of the punitive elements depending on how it's manufactured. Can you speak at all to the gross pricing? I noticed quarter-over-quarter your oil pricing came down quite a bit from about $9 to $5. So is that all excise tax considerations? Or is there other pricing considerations there?

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

Well, yes, I think that's certainly a consideration on the medical side, absorbing excise tax. But I'd say also, again, when you're looking at the pricing for oil, we typically aren't -- equivalency factor matters a lot, and I think that, that factor matters when you think how much weight you're using. Whether you're using trim or flower certainly plays a role in your average price per gram, which is why we're -- when we're thinking about this, I think you're going to see things shift towards the unit cost of, say, a tincture of oil rather than the amount of input that was used.

Matt Bottomley - *Canaccord Genuity Limited, Research Division - Analyst*

Okay, great. And just a follow-up on maybe just the continued penetration into the Canadian rec market. I know you said you'll probably telegraph exact channels in the future. But you're in 5 provinces currently, and you had, I think I looked quickly, about $11 million of inventory on hand at the year-end, $1.5 million of finished goods. So are you as a company capacity constrained in order to continue to penetrate into additional markets? And can you give us any color on when you think you'll get into maybe markets like Alberta or Quebec or some of the other big markets you're not in today?

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

Sure. So I think when we think of capacity, there's really 2 ways to look at it. So the first is cultivation capacity, and the second is really the downstream processing, packaging and other parts of the supply chain. So I'd say on the first, we think that we're doing well in terms of being able to access the cultivation capacity. But each time you add a province, you're adding complication to the other parts of the supply chain. You have to multiply your set of SKUs each time you add a province because of tax stamps. So making sure that we can manage the downstream logistics is really the biggest factor and when we'll add those provinces. And so we're in constant dialogue. We understand there are shortages in provinces, but we want to make sure that we can efficiently get product out the door to all partners we onboard. So I think you'll see that over time increase, but we want to make sure that we can get everything right and dialed in, in terms of automation before we onboard and spread across the entire country.

Operator

Our next question comes from John Zamparo of CIBC.

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

(inaudible) the taxation structure a couple times. I was wondering if you could comment on the draft regulations that you've seen for production and marketing restrictions on derivative products in October and how do you think that will restrict your ability to operate?

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

Sure. Well, I'd say overall, it's certainly a step in the right direction in terms of new formats that are allowed, and I think that there are some pros and cons. I think that there will be a fair amount of flexibility in the vaporizer space, which we're pleased to see. But I do think that the packaging rules for edibles will likely prove challenging, and we'll hope to see some revision or changes in there in the future. And specifically, I'm referring to the way that packaging will work on amount of dosage. I think that that's very different than what we've seen in other markets in the U.S. And also, I think some of the limits on co-manufacturing will limit the amount and the diversity of product format that will be initially available.

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

Okay, that's helpful. And my follow-up was on the M&A side. Maybe you could talk a bit about the opportunities and deal flow you're seeing. Are you encouraged by the assets that are available? And then what are your thoughts on valuations within the sector?

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

Sure. So I do have a background in M&A, so hopefully that'll come in handy. But the way that I look at it is, there are a lot of good assets available. One thing that is always a question is whether the regulations make it feasible for us to capitalize on those opportunities today. I think we tend to be attracted to assets that aren't always top of mind for most other companies, so we do see a lot of opportunities. But our focus really is on assets that we think will contribute to scalable value that we can take and transfer really across borders and across regulated channels, whether that's adult use, pharmaceutical/medical or the general CPG channel. So I think that there are a lot of opportunities, but I would say that regulations evolving will certainly play a factor.

Operator

Our next question comes from Owen Bennett of Jefferies.

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

Just one question for me. On GrowCo, you say it won't become operational until 2020. With this in mind, I was hoping you could give an estimate as where you would expect annualized calendar year and 2019 capacity to be at.

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

Sorry, the question is about GrowCo or prior to GrowCo?

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

No. So obviously, that's not coming operational in 2020, so I just wanted to get an idea of -- for 2019 where you think annualized capacity will be at.

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

Sure. So we think the second quarter this year, we'll have all the flower rooms planted in Building 4. And from a capacity perspective, once we're able to fill everything up, we'll be able to dial in and ramp up efficiency. So from a utilization perspective, I think we'll see that increase throughout the year. And then we also have Israel that we expect to be ready for the second half of the year, so I think that, that will factor in among the supply sources that we have.

Operator

Our next question comes from Vivian Azer of Cowen.

Steven Jason Schneiderman - *Cowen and Company, LLC, Research Division - Research Associate*

This is Steve Schneiderman here for Vivian today. Mike, while you didn't break out medical versus adult-use revenues, given the amount of tax, I think it looks like it's fairly fair to say that there was a sequential decline in medical revenues. And while that wouldn't be unique in this industry, what is your outlook in general for this part of the segment in particular? What are you seeing in terms of the interaction between medical and adult-use sales?

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

Sure. So first, I'd -- just would say we do absorb the excise tax for medical patients. So the effective excise tax for us as a company affects us regardless of whether it's medical or recreational. But overall, what we're seeing is likely going to be a larger decline in Canada than you saw in some of the U.S. states. And while it's too early to really use, I think the immediate data we're seeing because of the shortage, that you don't have enough supply that -- really where you allocate the supply is where you're going to see the demand. But there are different incentives in the market in Canada than there were in the U.S. states. For one, we haven't seen excise tax really apply to medical patients in the U.S., but we're seeing it here in Canada. And from a regulation and a distribution perspective, there are additional incentives for the government to push demand towards the recreational channel because they play a part in the distribution. So given that, I would say in the short to medium term, we would expect to see that decline faster than how it declined in the U.S. That being said, we do think there's a huge long-term opportunity in what I would say is more of a pharmaceutical market where you're able to focus on developing very tailored formulations with specific active ingredients that can target actual therapeutic benefits, different indications. Those will take time to develop, so you'll see that decline. But I think in the coming years, you'll see that market really start to build back up. We have a lot of preclinical results that are available and a lot of early indications that there is promise, but we still have a lot of work to do to be able to get those into a more formalized and traditional medical channel.

Steven Jason Schneiderman - *Cowen and Company, LLC, Research Division - Research Associate*

Okay, great. So moving on to Israel. With the upcoming election, it seems that adult-use cannabis has seemingly become increasingly topical over there. To the extent a pro adult-use candidate is elected, how does that change the opportunity for your Israeli business?

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

Yes. Well, I'd say this is something we're seeing in a lot of markets where the conversation is certainly shifting towards recreational cannabis. I think we have a huge regulatory tailwind globally. But we set ourselves up, and the IP that we developed for the recreational market is transferable. And a big reason for us to start setting up these manufacturing regional hubs is it ensures that whether it's a traditional ethical pharma market, a health and wellness or sort of a market like you're seeing start to develop with the Farm Bill or an adult-use market, we'll be well positioned to capitalize on the opportunity. So it's something that we'd be very excited for, and we think that would certainly be an exciting market for us.

Steven Jason Schneiderman - *Cowen and Company, LLC, Research Division - Research Associate*

Okay, great. And final one for me. As it relates to Cronos GrowCo, can you please elaborate on the structure of that venture and what Cronos' specific capital commitments for the construction of the facility is going to be?

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

Yes. So it's a 50-50 joint venture with equal contributions from each of the partners. And I'd say that the ultimate capital contribution will really be a function of the amount of leverage that's used in order to fund it. Obviously, we feel that it is -- to go back to that old metric that I don't love about funded capacity, we feel that regardless of whether we are able to access debt, that it's something that we will be able to fund. But it is our expectation that we'll be able to use some leverage. And then we would think of it as really sort of a third party from there where we are purchasing product and then, depending on the channel, either selling it as flower or processing it into pre-rolls or using it to serve in derivative products such as vaporizers and edibles.

Steven Jason Schneiderman - *Cowen and Company, LLC, Research Division - Research Associate*

And just to clarify, would that be pushing third party from the JV? Or is that just on a go-forward basis once that GrowCo is completed?

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

Yes, from the JV. I mean our model really does assume that cannabis will follow the same principles of economics we've seen in other industries where supply catches up with demand. One of the ways that we can ensure that we'll have an efficient supply chain and can use contract growers is by essentially building them with leaders ourselves. So we think it's going to be a great way for us to make sure that we don't sacrifice quality and, for flower-based products especially, we can have the genetics that we know grown in a way that we're used to. But that's really the model that we'll follow in most countries, is how do we find a way to -- if there aren't existing contract growers we can give our genetics to, how do we build up that infrastructure? And when we can find experts like the Muccis, the GrowCo, we're very excited about being able to bring them in early and work with them.

Steven Jason Schneiderman - *Cowen and Company, LLC, Research Division - Research Associate*

Okay. And we'll -- just to clarify, how much is the actual projected cost of the facility?

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

No, it's not something we disclose. So we'll give updates as capital contributions are made, but we haven't given any forward-looking guidance on that.

Operator

Our next question comes from Martin Landry of GMP Securities.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Just wondering, now that your partnership with Altria is closed, could you talk about what are the near-term goals that you want to achieve with the help of Altria?

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

Sure. So I think, first and foremost, when -- we think of ourselves still as an aggressive growth company. So talent acquisition is one of the key priorities. We think that that's really what's going to be the differentiator over the next few years. Product development and R&D is, I think the -- after human capital, is the biggest priority. When we think about Canada, the value that we see is having the opportunity to develop the processes and products that ultimately will be spread globally. So making sure that we accelerate that innovation, whether through organic investment or through external ventures, is going to continue to be a key priority. And then preparing and making sure that we set up a framework to be a leader in responsibility is something we think will be required to make sure that we are able to participate in what's -- we hope to be a very long-term, sustainable industry.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Okay, that's helpful. And now that edibles are going to be allowed this fall in Canada, I'm wondering, what's your readiness to tackle this market? And is it fair to expect that you're going to have edible products on the shelves this fall in Canada?

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

Well, I'd say we are hopeful, but one thing that is likely out of our control is the -- how the regulations are really finalized and implemented, how will retailers be ready. There's a lot of work, I think that still needs to go in. So I think that -- again, I'd say we're very hopeful. But as we've seen, there can and usually are delays when you try and bring on these types of regulatory frameworks quite quickly.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Yes. And is it fair to see that with Altria's partnership with Juul, that there could be something that could be brought, like vape pen or -- brought to the Canadian market with their help?

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

I think we look at the cannabinoid category as a very unique and distinct category from nicotine. While we both have Altria as a partner and access to the resources that Altria has, we think that the leading and winning device will be specifically tailored to cannabinoid formulations and to target very, I'd say, nuanced cannabis consumer need states. And so that's something that we're working on, on bringing a proprietary product to market. But we will and are excited to benefit from years of expertise and infrastructure at Altria in that regard.

Operator

Our next question comes from Graeme Kreindler of Eight Capital.

Graeme Kreindler - *Eight Capital, Research Division - Research Analyst*

I just wanted to ask, with respect to the pre-roll segment, I noticed that was around 14% of the revenues in the quarter. Is this is a segment that you think has a lot of long-term value for the company? And is there any sort of existing work or future work that could be done leveraging the partnership with Altria with respect to that vertical?

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

Absolutely. We've seen in -- certainly in tobacco, if you're looking for comps, that over time, that I guess you'd call the pre-rolled segment as well became very popular relative to loose flower or loose leaf, and we think that there's a lot of innovation that really can be leveraged. So it's a big focus of ours. We think as far as differentiation and branding, it's something that has a lot of opportunity. And we think, whether that's an advantage in the actual form factor and the presentation or in the efficiency of production, that, that will arguably be a bigger differentiator than just cultivation.

Graeme Kreindler - *Eight Capital, Research Division - Research Analyst*

And are you making any investments right now or trying to leverage any of the technology that Altria might have in terms of assembly lines or packaging, making that more efficient on the pre-roll side?

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

Yes, well, certainly, that's -- yes, I think a big focus for us is downstream processing in pre-rolls. When we talk about downstream processing, especially for flower-based products, it's a major focus. So yes, I'd say that, that is a -- that's a clear yes, and we have a lot of people to work with who have got quite a bit of experience. And really, while you may think of just Marlboro, there's a big [incentive] across a lot of other rolled and automated formats where we think that there's, again, a lot of opportunity.

Graeme Kreindler - *Eight Capital, Research Division - Research Analyst*

Okay. And then my other questions here are just more big picture. As we're entering or getting closer to derivative products coming online in the Canadian allergies market, sort of next-gen products with respect to what you guys are doing on R&D, is there any sort of expertise, again, with Altria in their experience dealing with federal regulators? Have they -- are they working at all with Canadian regulators with respect to some of the products you're looking to come online? Or are we still kind of too early days for that?

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

Yes, I think we've been able to, let's say, increase our regulatory dance, spend strength, I'd say, but the bigger focus is really on making sure that we have certain technologies ready and are able to -- whether that's leverage the rare cannabinoids and formulations and tailor them to the devices or be able to find different ways of optimizing bioavailability, taste masking, speed of onset for oral ingestibles, I think that's really the focus. And then what we need to do not just for Canada but for other markets to be able to collect data to get regulators comfortable and we think having that data set will become increasingly important over time.

Operator

Our next question comes from Rob Wertheimer of Melius Research.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst of Global Machinery*

There was an announcement out of a team out of Berkeley on use-based production of cannabinoids during the quarter, I think, and I just wanted to see if you saw that as support for the path that you guys are taking, whether there's any intellectual property threats or your general comments.

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

Yes, I think it's -- well, it's great to see others that are working on it and are having success. I think there's always this funny situation in entrepreneurship where if you look at a space and you don't have competitors, then that's not always a good sign. It may mean that no one else saw an opportunity.

But when you look at the space and you've got groups from MIT and Berkeley or the ones that are focusing on it, it's reassuring that even though it's not crowded yet, that there's huge opportunity. I think as far as the actual pathways and enzymes, I don't want to dig too deep into the assays that we're using, but we think that there's -- they're very different pathways as far as the specifics. So we don't really see it as a threat, but we do see it is as an area where focus will increasingly shift to as people start to understand the opportunity.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst of Global Machinery*

That's a very helpful answer. And then can you give us any sense of the cost per kilogram that you're targeting there? I don't know -- as the greenhouse-based or even field crop-based costs fall, are they approaching at all what you can see as possible for primary cannabinoids, I wish -- maybe you're not targeting THC, CBD? And then is it always going to be a case so that if that works, if the targeted costs, that that will be far lower? In other words is there a definitive cost advantage that you can continue to see even as costs fall on a -- and get optimized on, let's say, on the regular time-based production?

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

Sure. So without speaking to our specific cost target, I would say that Ginkgo felt comfortable in staking their compensation, on being able to achieve costs of less than $1,000 a kilo for the actual active ingredient, not for the flower.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst of Global Machinery*

Not for -- yes, exactly, yes.

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

As far as competing with field crops, I think it really will be dependent on the market as far as seedability. So I think if you're in a climate like Canada, it would be extremely difficult even outdoors to produce the -- to produce at the same level. The innovations we'll have to see would be likely using some type of transgenic or really sophisticated marker-assisted selection to have a field crop be able to compete from a specific cannabinoid production cost. I think CBD would be the -- has the best chance because it crystallizes easier, you can have genetics already developed and it's probably the easiest pathway biosynthetically to produce. The biggest advantage we see certainly is on the rare cannabinoids. But when we think of the purity advantage of being able to have end-to-end CGMP manufacturing and ultimately precision, we you start factoring in using chromatography columns when you're extracting, it gets very, very expensive if you want to reconstitute and have the same type of consistency you would have with fermented products.

Operator

This concludes our Q&A session. Like to turn the call back over to Mike Gorenstein for any closing remarks.

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

Thank you, everyone, for joining and hope you join us in a few months.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.