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CRON - Q2 2020 Cronos Group Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Lashana, and I will be your conference operator today. I would like to welcome everyone to Cronos Group's Second Quarter 2020 Earnings Conference Call. Today's call is being recorded. At this time, I would like to turn the call over to Shayne Laidlaw, Investor Relations. Please go ahead.

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

Thank you, Lashana, and thank you for joining us today to review Cronos Group's Second Quarter 2020 Financial and Business Performance. Today, I'm joined by our Chairman, President and CEO, Mike Gorenstein; our CFO, Jerry Barbato; and our EVP of Legal and Regulatory Affairs, Xiuming Shum.

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

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

In addition, during this call, certain financial measures may be discussed that are not recognized under 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. Reconciliation 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, crosstalk or minor technical issues during this call. We thank you in advance for your patience and understanding.

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

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

Thank you, Shayne, and good morning, everyone. To start the conversation, I'd like to speak about two issues affecting everyone around the world today. First, I want to address the topic of racism, and specifically, how we at Cronos, are dedicated to making a difference.

As a leader in the cannabis industry, we are committed to using our voice to lead our industry forward responsibly. We cannot do that without recognizing the historical injustice specifically tied to cannabis prohibition that continues to this day. As we continue to grow, entering new and evolving markets, we are committed to supporting meaningful and progressive social justice reform and legislation in markets such as the U.S. We believe this work starts from the inside out. So we have established a committee to address how we, as a company, can make an impact in the communities we operate in, both through our time and financial investment to fight racial injustice and inequity within our industry.

We are fortunate to have a platform, resources and influence, and we will continue to use it to do our part to combat racial injustice and to change society for the better.

Secondly, COVID-19 has impacted markets, industries and people globally, leading to material changes in the way we live and the way we do business. We've also seen the profound impact our products have in our consumers' everyday lives. And we continue to modify and monitor our distribution networks to bring quality products to market during this time. Cronos Group was founded on the mission to improve people's life by unlocking the full potential of cannabis, and our company has always been at the forefront of providing safe access and high-quality products to patients and consumers. As you know, my focus and company's focus are on creating long-term shareholder value by developing disruptive intellectual property and building iconic brands. I always encourage long-term thinking, especially in today's economy and environment. Cronos is truly building a business for the future. Our value will come from technology breakthroughs and branded sales that will help establish relationships with our consumers.

Moving to our operations in Israel. In June 2020, following the successful shipment of bulk dried flower from Canada to Israel, we commenced sales of PEACE NATURALS-branded cannabis to the Israeli medical market. This is an important milestone for Cronos, and we look forward to expanding our distribution and the PEACE NATURALS brand in the Israeli market.

The team at Cronos Israel is also preparing to introduce new SKUs in adjacent categories such as oils and pre-rolls, which will further establish our leadership position.

Allow me to take a moment to dive more into the Israeli market and how we've positioned ourselves as a leader there. Israel has a population of just over 9 million people and boasts one of the world's highest cannabis usage rates. Unlike the North American cannabis markets, Israel has a much less competitive illicit market given Israel's stringent border controls and security infrastructure. The Israeli government has taken several steps to optimize and expedite the patient access process for medical cannabis. In 2016, the Israeli Ministry of Health published a medical cannabis information booklet and guide, which includes a methodology intended for doctors to prescribe cannabis. This is meant to guide and assist in customizing treatment with medical cannabis. Many doctors in the Israeli health care systems have been trained and certified using this clinical methodology, which enables them to provide treatment and issue patients licenses for possession and use of medical cannabis. The Israeli Medical Cannabis Agency currently grants personal medical cannabis permits and prescriptions to patients to treat a variety of medical conditions. And unlike the Canadian Medical Cannabis Program, patients fill prescriptions directly through pharmacies. The medical patient count in Israel is expected to grow rapidly, representing an excellent opportunity for our business to grow in this market. The rapid growth in the Israeli medical market reminds us of the early days in Canada's medical market, with demand outpacing supply and the stigma associated with the product quickly fading away. Beyond the medical market in Israel, we are encouraged by the progress being made on further legalization of the potential adult-use market, which provides more legal access to cannabis in Israel. There are currently two bills being reviewed by the government, and they are progressing through parliament quicker than many had anticipated. As a reminder, Cronos Group consolidates the results and captures 90% of the economics through our equity interest across the Cronos Israel entities. With our manufacturing footprint, established local team, strong brand and product portfolio, we are very well positioned to succeed in the market.

Kibbutz Gan Shmuel is one of the largest and most sophisticated Kibbutzim in Israel, producing and exporting a variety of products to 35 countries throughout Europe and Asia.

For our Cronos Israel facility, we work closely with our partners at Kibbutz Gan Shmuel and are able to leverage not only their agricultural expertise but also their skilled labor pool with about 80 employees currently working on site and extensive infrastructure, including warehousing, utilities and much more. I am pleased to share that we are in full production and have had successful harvest.

Outside of Cronos Israel direct operations, we have further committed to the region and have a strong presence of an R&D and analytical sciences perspective. We have two partnerships with top cannabis researcher, Dr. Dedi Meiri, through the skincare repair research we are doing at Technion; and through the analytical testing lab on Cronos Israel's campus called Cannasoul.

Under our agreement, Cannasoul is developing a commercial cannabis analytical testing business on site at Cronos Israel. In addition, we have created our own research hub, Cronos Device Labs, which employs about 30 people and is focused on everything from understanding the effects of different cannabinoids to creating next-generation devices for cannabis products.

Turning to the Canadian market. In the second quarter, we continue to supply the adult-use market, working with provinces and private retailers to meet demand during this time. As COVID-19 continues to impact global markets and global supply chains, we have seen an uptick in sales, driven by consumer demand and the growth in retail outlets in key provinces. Despite the strength we have seen and the continued store openings in some provinces, we remain cautious knowing that the shock to the economy could potentially have negative impacts on our industry.

In Canada, we're now seeing most retailers open with limited capacity and social distancing guidelines. Several provincial purchasers continue to implement health and safety measures and reduced asset on-site operations, including limited delivery time slots, which have posed logistical challenges and create a reduction in purchase order fulfillment. The slowdown in disruption faced by retailers are in addition to quarantine measures and travel restrictions, which would impact the ability of consumers to readily access our products outside of online channels. These restrictions will continue to change and evolve, which creates uncertainty in forecasting consumer demand and sales velocity.

Despite the changing landscape throughout the second quarter, the Alcohol and Gaming Commission of Ontario continued to grant retail store authorizations with the objective of making the legal supply of cannabis more broadly available. With over 100 stores authorized to open as of July, Ontario seems to be committing to their plan of growing store count each month throughout 2020 and have a long runway for growth given the demand for new retail licenses.

In the Canadian 2.0 market, our adult-use brands, Spinach and COVE, and our direct-to-consumer a medicinal cannabis brand, PEACE NATURALS, continued to expand distribution throughout the country in their respective channels. We are proud of our uncompromising approach to quality, which is at the heart of everything we do. As we continue to glean more consumer insights into the Canadian market, we look forward to producing new and differentiated products over time.

We know the adult-use consumers and medical patients in Canada are looking for value during this time, and some of our peers have committed to a deep discount strategy as a way to provide this perceived value to the consumers and to compete with the illicit market. At Cronos, we believe that a real essence of value revolves around the trade-off between the benefits the consumer receives from a product and the price he or she pays for it.

We pride ourselves on the quality of the product we bring to market. For instance, our vaporizer devices aimed to deliver premium extract for consumers with precise cannabinoid concentration levels and terpene profiles for a consistent experience. The premium cannabis extracts are made using CO2 extraction processes, and each product has a unique and aromatic blend, which uses all-natural terpene-rich flavors. All of our batteries and cartridges were rigorously tested before sale, and we continue to receive positive feedback on these innovative new products.

We believe our consumer benefit and pricing profile provide a great value to consumers currently. We will continue to look at ways to provide more value to the consumer, whether through benefit or price on a regular basis as the industry evolves.

Moving to the U.S., I want to start off the discussion by welcoming Summer Frein into her new role as General Manager of our U.S. segment. Last month, summer was named General Manager of our U.S. hemp-derived CBD business with oversight of sales, marketing and operations. Summer officially joined Cronos in January of this year, but she has been part of the team since 2018 in her role at Altria. While at Altria, Summer led the strategy and business development teams due diligence in the cannabis space, which culminated in the strategic investment from Altria. She has been responsible for leading our U.S. sales efforts, including managing brand and retail partnerships for Lord Jones. Summer is a proven and results-oriented leader with 14 years of regulated consumer packaged goods experience. We're confident in our U.S. brands and our strategic direction under Summer's leadership.

There are many opportunities we see on the horizon, from introducing new product formats under Lord Jones to launching new brands and targeting different retail channels and consumers. Last quarter, in response to market feedback and part of our evolving effort to provide true value to our consumers, our Lord Jones brand launched a new size format for our hero product, the Lord Jones CBD body lotion. Now available in a larger 100 ml bottle, our popular body lotion is twice the size, but available at the same price as our original 50 ml size. In conjunction with this introduction, we lowered the price of our original 50 ml size by 30%. We think the new pricing structure provides for a great entry point to attract trial consumers into the brand and convert them to repeat consumers.

The support from our consumers during this quarter has been felt, and we're excited to be bringing these new format sizes and products to our loyal Lord Jones consumers.

We would be remiss not to mention the work we are doing with Ginkgo and our joint venture, Natuera. Following the successful fermentation of CBG at R&D scale at Cronos Fermentation, we have continued to optimize the process for downstream processing and scale-up procedures, and are very pleased with our results to date. With the progress we have made, we remain on schedule to produce fermented cannabinoids at commercial scale in September 2021.

And in Colombia, our joint venture, Natuera, successfully completed three additional test exports of hemp-derived CBD extract to the U.S. between May and July of this year for business development and R&D purposes. Although this does not signify the start of revenue for this business, they provide good learnings that set us up well for the future.

During these unprecedented times, it is very encouraging to see that we are making progress against our strategy across our global footprint. The current environment doesn't make things easy for any industry, let alone one that is in a nascent stage of development, but I'm very proud of our employees and all that we have accomplished during this time. From our production and manufacturing facilities to our continued R&D efforts, we are creating and launching new products and brands in different markets across the globe, and we are committed to bringing high-quality brands and products to our consumers.

There are few silver linings from this environment. First, given our strong balance sheet and decreased access to capital for industry competitors, we continue to feel that we are extremely well positioned to be opportunistic in how we create value for shareholders. Second, we believe that as attention turns to economic recovery, accelerating cannabis legalization is a great solution to help create much needed jobs and tax revenue. We can't always tell what the future holds, but we remain optimistic and ready to seize opportunities as they come our way.

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

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

Thanks, Mike, and good morning, everyone. Turning to our financial results. The company reported consolidated net revenue in the second quarter of 2020 of $9.9 million, a 29% increase from the prior year period. Revenue growth year-over-year, was driven primarily by the continued growth in cannabis products in the adult-use Canadian market and the inclusion of Redwood's financial results, our U.S. hemp-derived CBD business that was acquired in September of last year. Revenue was partially offset by non-recurring wholesale revenue in the Canadian market in the second quarter of 2019.

Consolidated gross profit for the second quarter of 2020 was negative $3 million, a $7 million decline from the second quarter of 2019. The decrease versus prior year was primarily driven by a $3.1 million inventory write-down on dried cannabis and cannabis extracts within the Rest of World segment caused by cannabis product price compression in the Canadian market as well as an increase in cost of sales, driven by a higher volume of adult-use sales and the lack of wholesale revenue.

If we were to exclude the inventory write-down of $3.1 million, gross profit in the second quarter of 2020 would have been $0.1 million, representing a gross margin of 1%. We anticipate inventory write-downs to continue in the short-term due to pricing pressures in the marketplace. Reported operating loss for the second quarter of 2020 was $34.8 million, representing an $18 million decline from the second quarter of 2019. The loss was due to a combination of factors; including a decline in gross profit, general and administrative expenses as a result of increased headcount, sales and marketing costs related to the development of new and existing brands and product lines, and R&D expenses, mainly due to increased spending on research at the Cronos Device Labs Research and Development Center and upscaling activities at Cronos Fermentation. Additionally, within G&A, we had $3.5 million worth of expenses driven by review costs and costs related to the company's responses to requests for information from various regulatory authorities related to our previously disclosed restatement of our 2019 interim financial statements. Our consolidated adjusted operating loss for the second quarter of 2020, which excludes the one-time review costs, was $31.3 million.

Turning to our reporting segments. In the Rest of World segment, we reported net revenue in the second quarter of 2020 of $7.7 million, a 1% increase from the prior year period. Revenue growth year-over-year was driven primarily by increased distribution of cannabis products in the Canadian market, including the launch of cannabis vaporizers in both the adult-use and direct-to-consumer categories, partially offset by nonrecurring wholesale revenue in the Canadian market in the second quarter of 2019.

Gross profit for the Rest of World segment was negative $3.5 million, a $7.6 million decline from the second quarter of 2019. The decrease year-over-year was primarily driven by a $3.1 million inventory write-down on dried cannabis and cannabis extracts, primarily caused by price compression in the Canadian market and the higher volume of adult-use sales and lack of wholesale revenue. If we were to exclude the $3.1 million inventory write-down, gross profit in the second quarter would have been negative $0.5 million, representing a negative 6% gross margin.

As we work to create an efficient global supply chain for 2020 and beyond, we anticipate that gross margins will continue to fluctuate. This is due to the current underutilization of certain manufacturing facilities that are being repurposed, and the work is underway to streamline our third-party biomass supply chain. We anticipate that these operational pressures will ease as our manufacturing and purchasing teams continue to make progress in these areas.

Turning to our Canadian cannabis vaporizers. As we have spoken about before, we made the strategic decision with our launch to utilize contract manufacturers to increase speed to market at the onset of cannabis 2.0 legalization. Further, we believe that contract manufacturing allows us to be more flexible and responsive to trends in the marketplace, while also aligning with our asset-light model. We continue to work with contract manufacturers to reduce costs while continuing to provide quality products to our consumers.

Reported operating loss in the Rest of World segment for the second quarter of 2020 was $22.1 million, representing a $5.4 million decline from the second quarter of 2019. The loss was primarily driven by a decline in gross profit and higher R&D costs related to our spending on research at Cronos Device Labs R&D scale center and upscaling activities at Cronos Fermentation.

Before getting into the U.S. business operating results, allow me to talk about the impairments we took this quarter in the segment. The company recorded $35 million of impairment charges on its reporting unit and $5 million of impairment charges on the Lord Jones brand. Due to the ongoing developments of the COVID-19 pandemic, closures of the retail stores have been longer than expected, and revenue growth has been slower than anticipated. With slower growth, the company's operating results in the U.S. segment have been negatively affected by the global pandemic. And the timeline of society getting back to normal is uncertain. Based on the valuations, the carrying value exceeded the fair value resulting in an impairment on both the reporting unit and the Lord Jones brand.

Turning to the U.S. segment. Reported net revenue in the second quarter of 2020 was $2.2 million. Gross profit for the U.S. segment was $0.6 million, representing a gross margin of 27%. We believe the decline in gross margins within the U.S. segment this quarter were transitory in nature, driven by premiums paid for our essential employees during the COVID-19 pandemic as well as increased discounts and promotions in the direct-to-consumer channel to drive online sales growth in an effort to offset the negative impact of retail channel customer closures due to COVID-19.

Reported operating loss in the U.S. segment for the second quarter of 2020 was $5.6 million. The loss was primarily driven by a decrease in gross profit, sales and marketing costs incurred in relation to the development and launch of new U.S. hemp-derived CBD products under the Lord Jones brand, new brand development and increase in headcount to support growth initiatives across a variety of functions.

Overall, Cronos Group reported a decrease in net income from the prior year, primarily due to the non-cash impairment charges and the change in fair value of the financial derivative liability associated with Altria's investment, which is described in more detail in the 10-Q. In the second quarter, the company recorded a non-cash loss of $35.9 million related to the change in fair value of these financial derivative liabilities. Cronos continues to expect there may be significant reported earnings volatility, primarily driven by the fair value quarterly adjustments related to the movement of Cronos Group's stock price.

Turning to the balance sheet. The company ended the quarter with approximately $1.3 billion in cash and short-term investments, which held relatively flat from the first quarter of 2020. Capital expenditures for the quarter were $8.6 million. This spending includes investments related to Cronos Fermentation, the PEACE NATURALS campus, our Israeli facility and our new ERP system, which I will talk more about shortly. We remain committed to deploying capital in a disciplined manner and only in ways that align with our strategic priorities.

Now I would like to provide an update on our remediation efforts in relation to the material weaknesses that we disclosed in our fourth quarter of 2019 filings. We, as a company, are committed to instituting best practices for financial reporting. Our management, with oversight from the Audit Committee, continues to work diligently to phase in our plan, and we have made substantial progress in the implementation process to date. We have implemented all the controls we laid out last quarter to address our material weaknesses and has begun rigorous testing internally. The testing by our independent auditor is in process on certain controls and will progress onto testing the rest of the controls throughout the course of 2020.

Lastly, to improve our efficiency as an organization, we successfully implemented an ERP system across our Canadian businesses, which went live in July. We have also commenced work to broaden the reach of our ERP system to our U.S. business, which is expected to be launched in the first half of 2021. The new ERP system will be a meaningful component of the internal control over financial reporting and enable us to reduce our reliance on manual controls and realize efficiencies throughout our supply chain and operations.

I continue to be encouraged by the work our teams are doing globally, both in our wholly owned business and with our JV partners. With that, I'll turn it over to Mike for closing remarks before Q&A.

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

Thank you, Jerry. Despite unprecedented shifts in the global economy and the way we live, Cronos has remained focused on delivering on our priorities, and we are well positioned to weather the storm. We are constantly assessing our consumers' shifting needs. Whether our consumers are seeking positivity, self-care or wellness, we remain committed to providing quality products with the level of consistency and quality that consumers have come to expect from our brands. Our strategy, which is built on multiple growth engines, is as vital as ever. Our growing diversified portfolio of brands, which participate across geographies, channels and categories, provide us with many ways to fuel our global business. And our asset-light model will continue to play a crucial role as we continue to scale our business.

Cronos has always been a company of people that thrive in new markets, embrace change and welcome hard problems. And by staying flexible, we are positioned to opportunistically create value as the landscape continues to shift.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Tamy Chen with BMO Capital Markets.

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

First question is, Mike, I think you said previously that with respect to your broader strategy, one part of it is you're sort of letting or waiting the industry kind of sort out both in Canada and even the U.S. before you embark on larger moves. So just wanted to get a sense, where are you on that? I mean, has the industry sort of started to develop or mature a bit more where you are looking at possibly making some larger moves in the business?

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

Sure. So when we look at, say, Canada, for example, and I'll answer the Canada and the U.S. separately, I think what we're really looking for is where our brands are unique products with -- in the relationship with consumers. And what we would want to see before making any larger acquisitions is stickiness of market share and carve-out of different consumer segments. We haven't really seen that happen yet. And I think the volatility in market share is something that continues quarter-to-quarter.

What's really important for us, from an ROIC perspective, is knowing that we're able to get something that hits the consumer need that we can take across borders and really be able to scale and build a moat with consumers. And I think it's still early in -- on the product and brand launches that it's hard for us to find something that it would be better for us, at least at this point in time, to make an acquisition versus continue to just build out ourselves.

And the U.S., I would say, it's really more of a regulatory question at this point. I think you do see a little bit more uptick in consumer relationship with brands. But watching and being proactive about how the regulatory environment develops, and I think with a lot of the different developments around COVID, likely accelerating our view of when we see legalization, I think that brings us closer to when we would be making one or more moves in the U.S. But still given the restrictions, it's, I think, not something that will happen immediately.

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

Got it. Okay. And my follow-up is on the Israel market. So following your comments there, I noticed that a number of your competitors in Canada are now also moving to import into the Israeli medical market. It's actually become what seems to be more of a net importer rather than, I think, previously expectations were that they would be a net exporter. So I'm just wondering, does that affect your Israeli strategy given your production hub that's there? And when you talk or think about the opportunity in Israel, the size of the market, and obviously, the population is smaller than Canada so I don't know if you're able to kind of quantify how many patients are right now, what the possible size of the opportunity could be down the road?

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

Sure. So I think Israel is an exciting market. And while we did originally think of it as something that would be used as an export hub, we would have been, and continue to be, pleasantly surprised by just the rapid growth in the medical market. It is a smaller population than Canada. So I think from a top line perspective, it is not likely to have the same addressable market size. But I will note that you just don't have the same type of competition from the illicit market. And that is an interesting dynamic that we haven't really seen in other markets.

I think from a competitiveness on cost and price, it's difficult to see Canadian exports in the long-term as being something that will continue to supply the Israeli market. For us, it's using our Canadian production to really supplement what we have there domestically right now. I think the -- just the conditions and the environment, Israel, make it just more advantageous to produce.

So I expect we'll continue to see rapid growth. We -- I think it's too early to be able to provide any specific numbers, but I do use the analogy that Canada, a few years ago, where -- if you go back, we're seeing a lot of growth in the medical market and there was a shortage. But now that we've been through the first reading in the Israeli Parliament over a legal -- more full legalization bill, I think when we look at our domestic footprint, it's something that will be essential and gives us a big advantage when we see legalization. And again, a smaller population, but -- and while still early from a structural perspective, I think being able to go direct from a producer to a store without any wholesaler should make it easier to scale. And from a margin perspective, we would expect to be more attractive. So I think the medical market is one aspect, and preparing for full legalization is also something that we're very focused on.

Operator

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

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

As you know, we focus a lot on your synthetic biology program. So Jerry, you referred to some increase in costs at Cronos Fermentation. Would you guys -- can we get an update on what -- where those costs are being attributed? How is the scale-up going? Mike, is the timeline associated with September of next year still holds?

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

Sure. Thanks. So I think the scale-up costs and there's some -- certainly some capex in different infrastructure, making sure that we have commercial fermentation infrastructure ready, having the different security packages, these are all planned capex, but there is some work that was needed to do to take the facility from when it was used and still for pharmaceuticals under Apotex converting it to be something that fits under C-45 is where some of the costs are. And we've been doing a number of runs, and we'll continue to increase production, so there are costs with that. But I think it's been going well and the increase in cost is a positive because it just shows we're continuing to ramp up and figure out downstream processing. So there will be costs as we build out the downstream processing trains to be able to efficiently take the fermented cannabinoids and make sure that they're just fungible in our supply chain.

So that in September, we're in a position where we can take cannabinoids from fermentation, or we can take cannabinoids from extraction, and they seamlessly fit into the products we have on the market today and into the products that we have in our development pipeline.

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

Great. Great. And one very quick follow-up question. Clearly, there's an expansion of your activities in the U.S. And as the regulatory environment starts to get clarified, particularly on CBD, how do you see potentially expanding or extrapolating that program into the U.S.

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

Yes. It's certainly a focus of ours. And I think it's not specific to CBD. There are other cannabinoids that we're again focused on. And I think that similar to Canada, we do plan to expand things. And when you look at how we're set up in the Canadian market, a lot of what we're doing is, of course, focusing on the Canadian consumer, but also trying to get learnings on how we can then seamlessly bring those products and those processes into the U.S.

So the products, we believe, that will win in the Canadian market, I think it just further advantages us for when we ultimately enter the U.S. market. And there are certain things you can do in the U.S. market and certain things you can do in the Canadian market. And once we're able to combine those, I think it's a much more powerful combination. So the Canadian market, the advantage is being able to work with -- and specifically on the more controlled cannabinoid side. So with THC, THCV, being able to work with universities, being able to have the type of infrastructure that we do and do that research is very, very important. Of course, the largest consumer market being in the U.S., we are still doing our consumer research in the U.S. and focusing on developing products that ultimately will be something that meet consumer needs in the U.S. market.

Operator

Your next question comes from the line of Andrew Carter with Stifel.

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

I wanted to ask about the Rest of World business and specifically Canadian adult-use business. So two quarters in a row where we've seen kind of the gross margin really deteriorate. And I know you mentioned lower pricing. So I guess a couple of questions, number one, when will we see kind of stability for the gross margins on this business? And then you do employ third-party for flower costs. Are you upside down on costs? Are you seeing flower cost ease at all? I will just stop there on the first one?

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

Great good morning, Andrew. So we're not going to provide guidance going forward on margins. But as we said in our prepared remarks, margins in the Rest of the World segment will continue to fluctuate over the next few quarters due to both market dynamics and our strategy, which we believe is setting us up for long-term success. I think we're confident on our asset-light model. But with that asset-light model, we're experiencing some margin pressure today. As the price of third-party flower comes down over time, our margins will improve.

And then just in the market, in general, we're seeing continued pricing pressure across the Canadian market where producers are lowering their prices and offering larger format size offerings.

And then as Mike talked about in his remarks, we are ramping up Cronos Israel's business and have just begun sales in that medical market, which will have some impacts on our margins.

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

Got it. And then kind of stepping -- stepping back and to kind of thinking about the Lord Jones business, it's been hit pretty hard by specialty taking kind of an impairment, which means you kind of reviewed the business. What are kind of your expectations of that business, if you could provide any kind of long-term targets for that business? And does it grow in the second half? Or is 2020 just going to be a difficult year with all the challenges from COVID-19?

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

Yes. Thanks again, Andrew. I think we're confident in the team and the go-forward business plans, but the external impacts are difficult to predict. And that difficulty led to us projecting out this business. And I can tell you that at the onset of 2020, we were very excited about the prospects for meaningful growth in the U.S. business. But COVID-19 pandemic has had a significant impact on many of our customers who've experienced temporary store closures and some of them have permanently closed, which has negatively impacted sales and demand, quite frankly, in the segment.

So for -- right now, it's very difficult for us to predict what the rest of 2020 holds. Because as you see stores open in some states and localities, they're having to reclose. And that what we -- what you really can't figure out is what's the impact on the consumer in the short run. Just because the store may open back up, you're not going to get the same foot traffic through the store and the interactions and the number of people allowed in stores.

Operator

Your next question comes from the line of Seth Rubin with CIBC.

Seth Rubin - *CIBC Capital Markets, Research Division - Research Analyst*

This is Seth on for John Zamparo. So I guess sticking to Lord Jones, there's some signs you can offset the loss in brick and mortar through online channels, either through direct to consumer or online retailers. And then any update on Lord Jones and the CBD strategy overall would be appreciated.

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

Yes. Thanks for the question, Seth. So while on the surface, it may seem a bit disappointing that our U.S. business was flat quarter-over-quarter, COVID obviously had a significant impact on our brick-and-mortar sales. But I would say, we did fairly well in the second quarter, having very little sales to our retail partners and focusing on our direct-to-consumer.

Now with that, we had a lot of price promotions and discounts to drive those sales. But quarter-over-quarter, in spite of having such little revenue to those retail partners and then as we look forward, I mean, we feel confident in the plans the business has to project -- to correct the trajectory of that business, and are very excited to see what Summer will do to lead the business forward.

Seth Rubin - *CIBC Capital Markets, Research Division - Research Analyst*

And just a quick follow-up, if I can. Just on your capital allocation strategy looking forward, could you maybe expect any significant capex projects in the pipeline?

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

We're always evaluating opportunities. But I think from the brand portfolio that we have right now, we're pretty comfortable with where we are from an infrastructure perspective. And I think, outside of any acquisitions or further launches where we might want to backfill margin with capex, we're pretty comfortable with where we are today. So not much to be expected there.

Operator

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

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

I wanted to follow up, please, on Lord Jones as well. Certainly, some moving pieces in the quarter, in particular, as we try to triangulate to a normalized gross margin. So on the one hand, you have the price reduction on your core offering, but then as well as increased promotion. But I would think that with the deflation that you're seeing in the commodity market, there should be some kind of offset. So is there any color you can offer as we kind of try to normalize for all those puts and takes, distribution, price adjustments and commodity deflation, what the gross profit profile would have looked like?

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

Yes. Thank you, Vivian. So yes, the margins in the U.S. were impacted by both components, both the revenue and the cost of goods sold in the quarter, both due to COVID and our response to that pandemic. If you start with the net revenue impact, we increased discounts and promotions to our consumers in that online channel. We pulsed in a lot of those 30% discounts. And then on the cost side, we paid our essential employees premium pay, which drove up our COGS. So both of those components negatively impacted margins in the quarter. I think it's hard to predict when our margins will get back to some sort of normality based on the COVID pandemic and the opening of retail stores. But you're absolutely right. I mean, some of our costs will be going down. The question is, is that offset by the premium pay? And from the revenue side, what happens with the retail environment.

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

Understood. Maybe just to follow up on that a little bit more specifically. Can you contextualize what you're seeing in terms of price deflation on the input for the Lord Jones product?

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

Yes. I think certainly, we've seen prices rapidly come down, but that does take some time to actually flow through to what you're seeing on margins. If you think of when, from an accounting perspective, new product -- or sorry, new input would actually match the products that we're selling, we do see it coming down. We think it could even come down further, but it takes time for us to flush through the current CBD supply we have on hand.

Operator

Your next question comes from the line of Piper -- Michael Lavery with Piper Sandler.

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

You have your PEACE+ looking like it's set to launch now in Arizona, California, Illinois and Pennsylvania. Can you give a little sense of maybe how soon that's coming? How broad of a launch it may be and why those states in particular?

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

Sure, thanks. PEACE+ is still something that we're monitoring the macro environment, whether regulatory or just what's happening with retail before, I think, aggressively expanding. And I think when you look at our focus for the back half of the year, we're really looking to a different brand, so Lord Jones and then a more mainstream skin care brand, that would be where our attention is.

Again, though having everything ready for PEACE+, we will be opportunistic time-wise to make sure that when we see the right timing, the right opportunity, we'll move forward with it.

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

So is there not a set schedule just yet?

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

There's not a set schedule. I think it's more of a case of timing, and we want to make sure that we bring our other brand to market first. And then having PEACE+ ready, we'll start rolling it out after that.

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

Okay. And just to follow up, I know we've covered Lord Jones pretty well already, but I just want to understand the thinking behind the write-down in the sense that I think, typically, in a situation like that, if it's considered transitory pressure, then you wouldn't have to take the write-down. Is there something beyond the COVID-19 pressure that you're pointing to as you're thinking on the market changed? Or is it more just a conservatism approach? Or just kind of how you thought about that?

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

Yes. It was a deep analysis that we looked at. And yes, there are some temporary pressures, and we haven't met expectations from the original model. And what we don't know and is difficult to predict for us is, hey, what -- how long does COVID last? And then how long does that impact on consumer behavior last? So yes, I would say, yes, we took a conservative approach. I just think with the COVID pandemic and the significant number of the company's customers who've experienced closures and pressures on their business, when we did the analysis, the impairment was the logical thing to do.

Operator

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

Your next question comes from the line of Bill Kirk with MKM Partners. There's no response from that line.

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

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

Mike, just wondering if I could get some additional commentary on your views on brand building, specifically what's happening in the Canadian market here where retail sales are obviously continuing to grow pretty healthily, whereas there are some dynamics with less in inventory throughout the sector and how some of your peers are pricing. So given the fact that a lot of your comparable peers out there with similar market caps, some of the larger names have a higher penetration, what's your, I guess, mix or trade-off between having, I guess, more of a measured OpEx burn from -- versus some of those peers versus brand building and just even selling products today at a breakeven just to get products out there, given that you can't really amortize and there's not much differentiation. When you walk into these stores, maybe it's not much of an issue. But just curious on how you think that will play out in the long term as Cronos looks to build their own brand domestically.

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

Sure. So that's a great question. And I think, first, I'll say, when we think of brand building, we're thinking on a global scale. And I think that while you can't do broad advertising and you have to be very restricted, there still are ways that you can advertise. But building a brand isn't really specific just to what your packaging looked like and being able to put up billboards. And our approach to value creation, I'll just -- I'll use an analogy of look at, say, the tobacco industry over 100 years ago. And if you go back and think about the early market, you can see some probably pretty similar to where we are today with the Canadian flower market and industry participants competing to figure out how to sell loose leaf tobacco. But the biggest value creation ultimately didn't come from who could outsell someone else in tobacco leaf, it came from researching consumer needs and being able to develop a breakthrough consumer product like cigarette. And we believe the path to value creation for Cronos is similar. So it's continuing to focus on what that breakthrough product is, being able to bring it to market, and not only being able to bring that product to market in Canada, but being able to then take that product and also launch it in Israel and the U.S. and other markets as full legalization comes online. So I think it's important that we do have product in market that we have the sales manufacturing infrastructure to be able to continue having relationships so that we're ready when we have differentiated products that come out. And I think we've got the right pieces in place with the work that we've been doing since Todd joined us as Chief Innovation Officer and how we incorporate differentiation from rare cannabinoids and different form factors into the products. But I believe that building a brand off of essentially flower, which is commoditizing, given the restrictions and regulations in Canada, will be difficult but there's still an opportunity from product differentiation. And that's really what we need to be able to do. Until we have a product that's different, I think consumers will be continuing to switch between brands, and we need to provide something that's better to the consumer.

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

Understood. That's helpful. And then just on the flip side of that, just looking at your balance sheet, which is one of the strongest in the sector, are you sort of comfortable at the current operating burn that you're at in order to fund those interim losses as you look for sort of longer-term brand building that more differentiated opportunities? Or is there a 4 to 6 months -- or 4- to 6- quarter path where you'd like to obviously get that to breakeven or above?

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

Yes. We're -- given, I think the way that we're set up and what we look at as end markets versus where we are today, the focus really is on what is the longer-term return on invested capital versus when can we be cash flow-positive. And I think that we are set up with a balance sheet where we can't absorb that, but we're really making investments to be able to develop and bring those breakthrough products to market where we think the most value comes from. That doesn't mean that we aren't always focused on costs, but our focus is on making sure that we can reduce and get rid of costs that aren't something that is providing a good return on the investments we make. But still, anything that we see opportunistically or that fits our strategic plan that we can make investments into, we're going to continue to make.

Operator

Your final question comes from the line of Graeme Kreindler with Eight Capital.

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

I just wanted to get a bit of -- bit more color regarding the change in the different segments. On the Rest of World revenue quarter-over-quarter. I saw flower revenues more than doubled in the quarter while the extracts were down. So I was just wondering whether that flower increase was driven by the exports to international markets. And wanted to get some more detail regarding the extract side of things, given the launch of vapes. Just wanted to get some more detail regarding what we're seeing in that variance and what's included in that broader category.

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

Yes. So I think what you're seeing, at least Q2 of 2020 versus Q2 of 2019, is while our revenue is relatively flat, we sold all of our products in the second quarter in the Canadian marketplace, either in the rec or medical channel. Whereas in Q2 of 2019, we had a large wholesale shipment. And I think you can't really look at the difference between extracts and flower, whether that's pre-rolls or even tincture oil and vapes on a quarter-over-quarter basis, I think there's always going to be fluctuations in the mix.

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

Listen, and just to add to that, I just want to point out a difference that if you're comparing us to peers, because we have our own distribution in Israeli entity, when we export from Canada to Israel, that's not something that shows up in revenue upon the export. It's -- once the product -- the branded product is actually sold through in Israel, that's when you would be seeing the revenue realized. So there's a bit of a delay, but I would think of less of like us export in Israel and more of just Israel as an operating company where you'll see revenue come from the same way you would see the Canadian revenue. And whether it's imported or produced in Canada is really just a supply chain issue.

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

Okay. Understood. I appreciate that color. And then just 1 quick follow-up. I appreciate the commentary prior with regards to the U.S.A. segment and its fluctuations in gross margin there. When looking at the adjusted operating loss, over a quarter-over-quarter basis, that's actually improved by about 15%. So I was hoping to get a bit more detail with respect to -- you got flat revenues, a decline in the gross margin, but the profit figure is actually increasing. Just wondering what's driving that.

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

Yes. I think a majority of that is just related to timing issues of when we're spending our money. So we had a heavy Q1 and a lighter Q2. So I would really chop it up to that. I think it's difficult to look at quarter-over-quarter in that business.

Operator

This concludes our question-and-answer session for today. Thank you for your participation. You may now disconnect.