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CRON - Q1 2019 Cronos Group Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Charlie and I will be your conference operator today. I would like to welcome everyone to the Cronos Group's First Quarter 2019 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, Charlie. And thank you for joining us today to review Cronos Group's first quarter 2019 financial and business performance. I'm joined by our Chairman, President and CEO, Mike Gorenstein; and our CFO, Jerry Barbato. Earlier this morning, Cronos Group issued a news release announcing our financial results, which are filed on our SEDAR and EDGAR 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'd 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 statement. Management can give 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.



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

Thank you, Anna, and good morning everyone. In the first quarter, we took important steps to fortify our foundation for success and value creation both in the near term and long term. We believe that we have created the building blocks that will enable us to capture the significant growth opportunities in the global cannabis market for the benefit of our shareholders (technical difficulty). I would like to start the call by discussing the investment by Altria before moving on to the business highlights and turning it over to Jerry to discuss the financial performance.

We are very excited to officially have closed the previously announced \$2.4 billion investment from Altria in March. We dedicated a lot of time and effort to close the strategic transactions because we are confident Altria is the right strategic partner to have in our corner as we grow and push our business forward. We are already tapping Altria's expertise in innovation and product development and look forward to continue to work with them. With Altria's backing, we expect to be better positioned to capture opportunities and accelerate the execution of our strategic initiatives as an adult use innovation leader, Altria's (technical difficulty) enables us to leverage their product design, manufacturing, marketing and distribution and commercialization capabilities.

Altria also has significant expertise that can serve as the foundation for Cannabis vape products as well as considerable experience with large scale manufacturing automation, pre-rolls technology and supply chain management. Like Altria, we believe that the best way to create value to the supply chain is by working with contract farmers and not being farmers ourselves. This belief is why we are working to expand our production footprint globally by setting up co-manufacturing with agricultural partners and we believe in the future, Altria can be helpful in these efforts given its own agricultural relationships.

Another key benefit is the decades of experience that Altria brings in successfully navigating complex regulatory landscapes. That expertise, which spans taxation, product registration, shipping, licensing, government regulatory affairs and other legal issues will be critical to Cronos as cannabis markets develop, legalize and open around the world. We are excited for the many opportunities we expect this relationship to create. Already, we are beginning to see the benefits of Altria's expertise, which has been instrumental in putting our strategies in motion.

For those who are new to the Cronos story, I like to start each call by briefly reviewing the four key aspects of our strategy. At Cronos Group, we are establishing a global production footprint, which we believe will be instrumental in creating an efficient supply chain for the future. We are developing a diversified global sales and distribution network. We are creating disruptive intellectual property and further we are growing a portfolio of iconic brands and products that resonate with consumers. During this call, we'll do a quick update on each aspect of our strategy and what we were able to achieve since our fourth quarter earnings call.

In the Canadian market, our wholly-owned licensed producer and center of excellence Peace Naturals and specifically Building 4, our state-of-the-art, purpose-built 286,000 square foot indoor facility is continuing to come online. As many in the industry have noted, the time it takes to get licenses and approvals has increased. We are awaiting licenses in the last remaining flower rooms in Building 4. We still expect all flower rooms to be populated in the first half of 2019 and we are constantly working on dialing in efficiencies and improvements in yields towards full run rate capacity in the facility's future.

We're also seeing progress with our production joint venture in Colombia. In March 2019, a wholly-owned subsidiary of NatuEra received a license from the Colombian Ministry of Justice and Law to cultivate psychoactive cannabis. In addition to its existing licenses to cultivate and manufacture non-psychoactive cannabis and products. This license will allow for the cultivation and the manufacture of derivative products. Although we received this license for psychoactive cannabis, our initial focus will be more heavily weighted towards growing hemp and CBD base production.

We are in the process of working on the design of the production facilities with our partners and we'll provide more information on the status of this facility as soon as we have more definitive designs to share. We continue to expand our distribution footprint in the Canadian market for the adult-use channel. In January 2019, Cronos Group secured listings with a number of private retailers in the Saskatchewan province. Together with our currently established distribution in Ontario BC, Nova Scotia and Prince Edward Island, we have secured listings in five provinces, which represent approximately 58% of the Canadian population.

As our Canadian production capacity grows and comes online, we intend to strategically increase distribution within existing markets and expand into additional provinces and territories in Canada in a calculated methodical manner. We want to make sure we can adequately supply our current



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footprint on an ongoing basis before expanding in new markets. In January, the Israeli government approved the export of medical cannabis from Israel. This law will allow medical cannabis license holders who meet specific quality certifications to explore medical cannabis.

We intend to pursue export of medical cannabis products from Israel once production operations have commenced at our facility. As a reminder, Cronos Israel is Cronos Group's joint venture with the Israeli agricultural collective, Kibbutz Gan Shmuel. Cronos Israel is focused on the production, manufacturing and distribution of medical cannabis. The greenhouse manufacturing areas of Cronos Israel are in full construction mode. We anticipate that the construction of the 45,000 square foot greenhouse will be completed in the first half of 2019 and construction of the manufacturing facility will be completed in the second half of 2019. Cronos holds an effective 90% economic equity ownership across the entities in Cronos Israel. This week, we also launched Cronos Device Labs, an impressive R&D facility with certain assets purchased from Altria Israel to accelerate our development of disruptive intellectual property. Cronos Device Labs is focused on supporting the development of next-generation vaporizer products. The state-of-the-art facility will serve as our global R&D center for vape technologies. The experienced team of 23 people is comprised of product designers, mechanical, electrical and software engineers and analytical and formulation scientists with extensive experience in vaporizer development. We know that the vaporizer space is one of the fastest growing and evolving categories with many consumers migrating to this convenient, non-combustible consumption method.

At the same time, the category remains in its infancy with few products that are specifically tailored for cannabinoids. These products are even less developed in delivering full spectrum effects in a consistent and controlled manner. At Cronos, we are using the plant as a blueprint to learn and then create differentiated active ingredients. We will do this by reconstituting cannabinoids and terpenes in combinations that have specific psychoactive effects and/or potential therapeutic benefits. We then formulate those active ingredients to optimize bio-availability and customize them for the appropriate delivery systems, depending on the product.

And Cronos Device Labs is specifically designed for doing just that in the vaporizer category. This new initiative is expected to significantly enhance our technology and development capabilities, and ultimately we believe allow us to deliver expanded consumer product offerings, specifically tailored to cannabinoid use. We know that vaporizers will be an important product category, and one that we're committed to leading through innovation, research and product development.

To conclude this call, I wanted to talk about our efforts and responsibility and our commitment to consumers and all of our key stakeholders on this important topic. In April, our adult-use cannabis brand Spinach partnering with Arrive Alive DRIVE SOBER and foodora to encourage responsible sober driving. Every dollar raised goes directly to the campaigns' road safety initiatives. The campaign works with the police services, public health units, schools, community groups and businesses to help spread the message of safe and sober driving through resource sharing, public campaign and awareness events and Spinach is committed to advocating for responsible adult-use to raise awareness about impaired driving.

We are confident that we are positioning the company for long-term success by investing in innovation and responsibility and ultimately in our business. Our strategy is focused on long-term sustainable growth and we believe what we are building will continue to resonate with consumers and will generate long-term shareholder value.

With that, I'll turn it over to Jerry to provide a discussion of this quarter's financial results.

Jerry Barbato - Cronos Group Inc. - CFO

Thanks, Mike, and good morning everyone, I'm excited to be part of my first Cronos Group Earnings Call. Both our press release and MD&A includes comparisons of our financials to the same period in 2018. Currently, we believe the best way to evaluate our business and the industry is a comparison on a sequential quarter basis. The industries have gone through substantial change since the first quarter of 2018, primarily driven by the opening of the Canadian adult-use market. With that said, I will focus the majority of my comments discussing the first quarter's performance versus the fourth quarter of 2018.

We also believe adjusted EBITDA is one measure along with the fourth quarter of 2018. We also believe adjusted EBITDA is one measure along with net revenue, kilograms sold and average selling price to evaluate the operating performance of the business. Adjusted EBITDA removes the impact



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of items that may distort underlying business trends and results. We have included a reconciliation of net income to adjusted EBITDA in our MD&A and our press release.

The company reported an adjusted EBITDA loss of \$8.9 million in the first quarter of 2019. The loss increased by 13% from the fourth quarter of 2018, primarily due to increased operating expenses, partially offset by a increase in net revenue. The company reported net revenue of \$6.5 million in the first quarter of 2019, an increase of 15% from the fourth quarter of 2018.

This increase is primarily due to two factors, first, dry flower wholesale revenue in the fourth quarter, which carries no excise tax reduction for 2019. The sequential growth continues to be impacted by the supply constraints in the market. As Mike mentioned, we expect to have additional production capacity online in the second half of the year as we balance meeting demand today with focusing on the long-term strategy of our business.

As we continue to invest in our business, our brands and R&D initiatives, our adjusted EBITDA will likely decline over 2019, will position the company for accelerated growth in 2020. Kilograms of cannabis sold increased 7%, to 1,111 kilograms in the first quarter of 2019 from the fourth quarter of 2018, primarily due to increased 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 and with momentum for revenue growth building in the second half of the year. Average selling price for the first quarter of 2019 increased 7% to \$5.73 from the fourth quarter of 2018.

As previously mentioned, this is primarily driven by the increased revenue resulting from CBD oil, which carries no excise tax reduction. We believe gross profit before fair value adjustments provide useful information to understand and evaluate operating performance by excluding the non-cash fair value adjustments associated with biological assets and inventory. Gross profit before fair value adjustments for the first quarter of 2019 was \$3.5 million, an increase of 42% from the fourth quarter of 2018. This sequential increase in gross profit before fair value adjustments was largely driven by an increase in kilograms sold and a higher average selling price for reasons already discussed as well as a reduction in cost of sales before fair value adjustments per gram or fully loaded unit cost of goods sold. Unit cost of goods sold decreased by 11% to \$2.69 in the first quarter of 2019 from the fourth quarter of 2018. This was primarily driven by productivity gains realized in our cultivation operations.

Operating expenses for the first quarter of 2019 totaled \$13.9 million representing an increase of 12% from the fourth quarter of 2018. The increase is primarily driven by professional fees for services in connection with various strategic initiatives and increased staffing levels across all functions within the organization in line with the company's growth strategy. In order to carry out our 2019 strategic objectives, we look at functions over the course of the next three quarters. Additionally in March 2019, Cronos Group sold all of its approximate 19% equity interest in Whistler Medical Marijuana Corporation to Aurora Cannabis in an all share transaction. At closing, Cronos Group received approximately \$24.7 million in value of Aurora common shares with the company subsequently sold for approximately \$25.6 million in cash.

Subject to the satisfaction of certain specified milestones the Cronos Group expects to receive an additional \$7.6 million in value of Aurora common shares. Based on market conditions at the time of the transaction and assuming all milestones are met, Cronos expects to generate in aggregate a return of 8.7x on its investment in Whistler. You'll also notice that on a reported basis, the company reported a significant increase in net income due to various one-time items, which are described in the MD&A and the financial statements. I would like to comment on one of those items. Altria's investment included a warrant and other financial derivatives that allow Altria to acquire additional shares in Cronos Group.

Cronos Group will report these financial derivative liabilities at fair value each quarter. As such there may be significant reported earnings volatility, primarily driven by quarterly adjustments related to the movement of Cronos Group stock price. In the first quarter, Cronos Group recorded a non-cash gain of \$436 million related to the change in fair value of these financial derivative liabilities. We've included additional disclosures in the financial statements regarding the investment, the accounting treatment and the impact of the financial derivative liabilities.

Turning to the balance sheet, as of March 31, the company's total cash position was \$2.4 billion. In addition to providing us meaningful liquidity, the Altria investment affords us the flexibility to capitalize on opportunistic external growth opportunities and accelerate organic growth initiatives.



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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, GroCo and Israel facilities.

As you are aware, the pending regulations related to the legalization of derivative products, which include vaporizers and edibles in the Canadian adult-use market will require increased investment as we work our way through 2019. Additionally, the launch of our vaporizer innovation center in Israel, Cronos Device Labs, will require investment to develop next-generation technology for cannabis and cannabinoid vaporizers.

This concludes my review of the financials for the quarter ended March 31, 2019.

I'll turn it over to Mike for closing remarks.

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

Thank you, Jerry. In closing, the business in the first quarter of 2019 performed in line with our expectations. We continue to stay focused on creating a leading cannabis company that is well positioned to capture the expanding global market opportunity by building our supply chain, distribution, intellectual property and brand portfolios. We are delighted to officially close our transaction with Altria and to kick-off a relationship we expect to drive significant growth and value creation. This investment as well as numerous other actions taken in the quarter and the quarters to come will provide a strong foundation for Cronos Group.

Let's now open the lines for questions.

QUESTIONS AND ANSWERS

Operator

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

Tamy Chen - BMO Capital Markets Equity Research - Analyst

Thanks. Hi, everyone. My first question is just wanted to talk on the inventory for a second. I noticed that the finished inventory was a bit modest at the quarter end with more of it was work-in-progress. And just given the time that it seems to take now to convert harvest and unfinished products into the finished packaged goods, I am just wondering how should we think about the sales ramp for the next quarter and even for the second half of 2019?

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

Yes, thanks for the question. I wouldn't read too much into one quarter's activity. As we mentioned on the call, our production at Peace will continue to ramp up over the course of 2019, and we believe that harvesting more kilograms each quarter would naturally increase our work-in-process. And given that it takes about 45 days for vape [ph] to go through drying, curing, and testing before it could be bottled, so work-in-process increases, further pronounced by this gestation period.



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

Okay, thanks. Got it. And my follow-up is just wondering on the Israel R&D center, why there versus elsewhere? And can you talk a bit more about what you mean by next-gen vapes? I think there are some vape products that exist today with some level of metered dosage. So is it -- is that it's a new type of oil formulation? Or is it new additional features of technologies on the pen itself that you are looking to develop?

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

Sure. Thanks. Why Israel? I think really we look at Israel as a global leader in cannabis research. And we already have production operators there with Cronos Israel, a partnership with Technion for preclinical trials for skin repair. And one of the things that was important to us is making sure that we could accelerate this initiative. And so we actually took over the facilities and employees from former Altria entity Altria Israel. So it's not a Greenfield operation, but it's a fully established R&D facility with technology, equipment, and talent that's already intact. And we think that the best course of action is to use our own R&D capabilities to develop the vapor product. But I think when you look at what's out there and you think of how these devices will come online, it's important to look not just at what the device itself is, but how that device is developed in connection with the formulation. So what we're seeing other areas is that the formulation tying into the heating coil, understanding how to adjust the temperature control, tying that into meter dosing, how much vapor is being released depending on what your consumer target is whether that's a large amount of vapor being released versus a smaller softer amount really can affect what occasion you are targeting. So I think it's putting all those together and taking those building blocks, combining that with understanding what the spectrum of cannabinoids that we are using are, whether that's primarily a THC or CBD based formulation or whether that's really making sure that the heating points are preserving flavor and really getting the most out of the rare cannabinoids that we are using. Having that platform, technology in-house and being able to iterate across vapor and flower, I think is very important.

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

Got it. Okay. Thank you. That's it from me.

Operator

Your next question comes from the line of Chris Carey with Bank of America. Your line is now open.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Hi, thanks for the question. So I guess just from a capacity standpoint, right, you did about roughly 1,000 kilos in the first quarter and have or are working toward approximately 40,000 kilos in the near term. How soon do you think that gap can close? And what really needs to occur for that to happen? Is that the Canadian supply chain, you need more distribution points to start to open up? Do you need more export markets to start to open up? So I wonder if you could just provide some perspective on that.

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

Sure. As far as capacity, we expect that everything is planted in the second quarter and then it's really a matter to continue to dial things in as we go. As far as distribution points and how we work through the supply chain, I think it's -- a big factor here is going to be what those ultimate formats are. So you'll start to see also how we allocated for what product formats and that's really going to affect what the filling, packaging and shipping is. So, I think you'll see a lot of that towards the end of the year with the expected and planned change in regulations for what products we can release, start to open things up. And we expect that that may have a even bigger effect in terms of opening the types of products and just the number of distribution of retail points that open up. And that's a very important market for us. So making sure that we are prepared is a real big an issue for us.

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Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Okay, okay. Thanks. And so just more broadly, right, you've got over \$2 billion on the balance sheet and we've recently seen in the market, there are ways to create value that may be earned so obvious in a number of (technical difficulty)

Operator

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

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

Hi, good morning. My first question was on, Mike, your comment on Colombia and your decision to prioritize hemp over marijuana, can you just offer a little bit more color on what informed that and how you're thinking about end markets and market sizing? Thanks.

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

Thanks, Vivien. So, a lot of what we're looking at is either import/export, and while you know we still will use and maintain the psychoactive license when we look at regulations for different product categories, and we start thinking of kind of the three main distribution channels. On one hand, you have traditional ethical pharma, and you have former regulations on import/export, it's kind of what you see in Germany. All the way on the other end of the spectrum, you've got recreational where it's extremely difficult to import/export. This middle category, whether you're thinking of things opening up for the farm bill or what we expect to happen with CBD in the EU over the next 18 months. We see borders falling much faster for non-intoxicating products primarily that are CBD-based. So having a scalable production base or input for CBD is something that's important, and I think that that market globally is going to expand probably more rapidly than the THC market, just based off of the ability to import/export. Otherwise, a lot of that product will likely be shifting towards domestic production for adult-use.

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

Thanks. And just a follow-up on that in terms of kind of capabilities around finished goods, is that something that you want to bring in-house, because at least based on what we're seeing in the US, delivery formats for CBD have been highly varied, how are you going to address that?

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

Yes, I think it really depends on which format. So there are certain formats that it certainly makes sense to bring in-house, and I think the more specialized and the more we feel we need to be able to have control to ensure that we've got consistency in quality and safety, we'll be bringing those in-house. And then I think there are others where we feel that along the value chain, we can use co-packers and co-manufacturing. So depending on the type of the oral ingestible versus vapor, where we know there are sophisticated and highly experienced partners that we can leverage, we certainly will do that. I think it also depends on which geography you're looking at, whether or not it's us shipping in ingredients, and then locally manufacturing versus being able to ship final product. So I don't know if it's simple to say, all in-house versus all-contracted. I think it really depends on which geography and ultimately which product.

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

Okay, that's helpful. And just my last one, on your comment around expanding your distribution and presence in Canada, as you get more supply online, clearly there's a balance between going deeper into provinces, where you're already present versus expanding into other provinces. And I just wanted to hear kind of your extended thoughts on that, Mike, because you've had a bit more of a nuanced view around kind of the ability to brand build so early in the market? And so does that inform how you think about that choice, brand versus equity [ph]?

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

Yes, thanks. That's a great question. I think when we look at -- normally your issue is when you launch a product, it's trial. How can I get someone to try a product given how much of a shortage there is. I think right now, it's really about driving repurchase, and trying to get as much horizontal or let's say, virtual shelf space as you can right now launching a lot of SKUs across the country. Really when trial isn't a problem, doesn't necessarily help for repurchase if you had stock out. So our preference is to be able to have in those provinces the ability to start building up relationships with customers, be able to continually drive repurchase, and then expand from there. I think also, again, when we think of formats in different categories and allocating supplies, we want to make sure that we can still fill a pipeline for new products that come online and follow that same strategy that will have enough inventory knowing that there is a quick supply ramp for us to be able to make sure that in other formats where we think it's easier to build brand equity across Canada, we're really able to make sure that we get repurchases after trial.

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

Perfect. Thanks very much.

Operator

Your next question comes from the line of Martin Landry with GMP Securities. Your line is now open.

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

Hi, good morning. I just want to come back on the inventory balance, Mike, in Q4, you had alluded to some bottlenecks or challenges in downstream and processing and packaging. I was wondering has the situation improved, have you resolved these bottlenecks, and are you -- do you feel more comfortable with your post-harvest capacities?

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

Yes. Thanks. Good morning. I think that's something that is resolving and that we're working towards, but is not fully resolved yet. And I think as we're continuing to ramp, it's something that we think should be resolved over the next few quarters, and it will likely come in different formats at different times. So we focus on making sure that we're able to automate in one category, while still making sure we have some product going out the door manually in others. But it does take time to set up automation lines for all products. But we do see that continue to improve and ramp and that's really being accelerated by a lot of help we're also getting from pretty experienced packaging engineers and automation experts from Altria.

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

Great. And giving that your finished good levels are at similar levels as they were in December, how do we look at revenues for Q2? Should that imply that your Q2 revenues are likely to be stable versus Q1 or you still expect some growth there?

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

Yes. I think it should be relatively stable, you'll see some growth. But as we said earlier, we really plan to ramp up finished goods in the back half of the year.

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

Okay. Okay, thank you very much.

Operator

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

John Zamparo - CIBC Capital Markets, Research Division - Associate

Hey, thank you. Good morning. Wanted to ask about capital allocation. So similar to a question that was asked previously, and my apologies, I may have been cut off from the call briefly. But, Mike, you've been clear that you want to prioritize R&D and intellectual property, and that you're looking to avoid buying business plans, but I'm wondering what are your thoughts on quality and valuation of assets in the US market and would you potentially look at an acquisition that gives you optionality in the US?

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

Thanks. Yes, I think that when I talk about business plan versus businesses, a lot of that does relate to just general maturity of the business, whether specifically it's I've applied for a license, do you want to buy my business, versus we've built up a community and we have really strong relationships already built with customers. I think that those are one of the things we look at in the US, is having that relationship, having real velocity on a brand that we look at as valuable. And I think footprint and distribution versus brand is something that we do feel we have strong relationships already built in the US on the distribution side, but brands are something that's important, and I think that you can find still good value. You certainly have to look at where growth is going to be coming and sort of project forward a little bit, but I think that it's still available. Certainly, regulations will play a very, very big factor in how those brands and those businesses continue to grow. And I wouldn't say it's specific to the US, but we do still see that there are a lot of different innovation initiatives globally that certainly have value, and we do think about speed to product development and generally what is disruptive and scalable, so that regardless the Board will always continue to be the top of our priority list.

John Zamparo - CIBC Capital Markets, Research Division - Associate

Okay, that's helpful. Thanks. And my follow-up is on Cronos Device Labs, I just want to make sure we're right to interpret this move as Cronos being interested in not just the vaporizer space, but technology that focuses on the rare cannabinoids that you're looking to generate with Ginkgo, is that fair?

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

That's 100% fair. I think, again, whether it's edibles, whether it's capsules or vaporizers, depending on the cannabinoid, you really want to tailor the delivery system to the experience you're trying to create. So we put so much time and effort and thought into how to combine different cannabinoids and Terpenes to create experiences. And in order to maximize that effort, it's important that the delivery system fits in with the cannabinoid formulation that we put in. Also on that is, I think from a brand perspective and as we gain insights from ethnography studies, ultimately, what that device could be maybe very different depending on the cannabinoid formulation just in terms of form factor. And when you compare cannabis vaporizers to, say, tobacco vaporizers, you have a much bigger range of what consumers want. So one vaporizer may score very high in a focus group for adult males, but score very low for adult females. And then you'll see something that's completely reversed. And I think it's important to have a suite of products that address different consumer needs versus trying to have one-size-fits-all.

John Zamparo - CIBC Capital Markets, Research Division - Associate

Okay, that's great color. Thank you very much.



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Operator

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

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

Good morning, everyone. Just wanted to touch briefly on the strategy for launching derivative products. Hopefully, industry-wide by Q4, we'll start seeing those rollouts. Just going back to your inventory balance not to beat a dead horse, but how should we look at your strategy with respect to kind of selling everything you can, given that there's a bit of a product shortage countrywide versus stockpiling a bit for a Q4 rollout. Do you think it's important to hit the ground running in the vape and edibles or whatever the categories are, or are you kind of playing it purchase order by purchase order now as the market evolves?

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

Thanks. I think right now it's certainly a balance between selling everything you have and making sure that you can load for launch. But a lot of the work that we've done, a lot of the data we've been collecting over the last few years has to do with post-processing and one of the reasons that we've been hesitant to accelerate third-party purchasing and contract growing for flower-based products is it's really difficult to get a consistent product, if it's not the same genetic or grown in-house. For vapes, there is a lot of we can do to bring in biomass or third-party extracted products and then re-inject or recombine different terpenes and cannabinoid mixtures to have something that's actually standardized and then release. So given that, I think it allows us to actually accelerate and be a little bit more aggressive and we think vapes, the category is very important to us and making sure we're able to launch with significant inventory is something that we are continuing to prioritize. So I think that when we think of the categories, we're certainly hoping by June we're going to have the REGS publish and go final and assuming that's the case, we will start to be quite aggressive in making sure that we have a pipeline of products.

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

Great. Thanks. And then on the other side of things just on the retail side. Just wondering if there's any highlights or updates on your relationship with MedMen or even outside of that, how that tender process might be going if there's certain provinces, maybe Alberta, where you think you might have stores open?

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

Sure. So it's still an extremely strong relationship. I think at the end of the day, the cannabis business is a relationship business. And we've looked at the relationship with MedMen always as something that would start in Canada and expand globally. So we still continue to work with them. What we've seen and this is certainly no secret to any industry observers is that right now, retail licenses certainly have slowed down. We do sort of have and it's a little bit chicken and egg problem. But as infrastructure needs to come online, it's important to watch how licenses are handed out. We're hopeful that by the start of next year, we'll start to see more licenses in Ontario. One of the benefits of the MedMen partnership versus us starting a new brand is, we don't feel that the same urgency to try to get brands on shelf to create brand awareness is something that we face with MedMen. We still look at it as the most established retail cannabis brand really by far and so we feel that we can wait until we can deliver a customer experience that's close to the customer experience you'd have in a MedMen versus Hollywood store. And I think being able to do that once value-add products are online, once supply starts to catch up, we don't feel that there's any disadvantage by not having one of the earliest license given how strong the brand continues to be.



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

Great, thanks. I know there's only two questions, if I can just put a housekeeping item in there very quickly, are you able to disclose your percentage of revenues this quarter that were to Germany versus Canada?

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

Yes, I think you should have seven international broken out, it should be in the financials.

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

Okay, apologies. I'll look there.

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

All right, thanks.

Operator

Your next question comes from the line of Graeme Kreindler with Eight Capital. Your line is now open.

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

Yes, hi, good morning, and thanks for taking my questions here. The first question I had I just wanted to get an update on progress at GroCo and considering the announcements out of Health Canada yesterday and changing in the licensing, if that would have any effect on the timeline?

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

Sure. Yes, progressing quite well, I think it's a large enough structure that it's certainly quite public as to where it is progress wise. As far as the announcements yesterday, it's something that we already have an application in for, so we don't know that it would have much of an effect one way or the other, we're hopeful that not just for GroCo, but also for other initiatives we have that this will have the effect of streamlining the licensing process. I think that there were a lot of applications going in and we think that anything that would -- anything that suggests service standards or kind of reallocating resources and prioritizing applications that Health Canada believes will imminently lead to more supply would be something that's more of a benefit to us. So we're certainly optimistic and we're really pleased to see that there is a conscious effort being made to make sure that the program runs smoothly in Canada.

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

Okay. Great, thanks. And just another question here, I wanted to follow-up on the Colombia assets and with respect to growing more hemp there. Just wanted to get a bit more clarity, from my understanding there's a lot of supply of hemp biomass available in Canada and that continues to increase in the United States. So with respect to the amount of supply that's out there in the market and focusing on growing that in Colombia, is there a significant cost advantage that you're expecting by focusing on the cultivation there?



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

Thanks. Yes, I think there is and it's not unique to hemp, it's really to generally just agricultural products, labor, climate, the number of cycles you can get per year, you've got a pretty big advantage in Colombia overall. So I think that's certainly a driver. And when you start looking internationally and again for the deregulated space, we do see that having a low cost of production is going to be something that's going to be really important to drive margins long-term.

Graeme Kreindler - Eight Capital, Research Division - Research Analyst

Okay, great. That's it from me. Thank you very much.

Operator

Your next question comes from the line of Robert Wertheimer with Melius Research. Your line is now open.

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

Hi, this is Rob Wertheimer. Is this me?

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

Yes.

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

I'm sorry, the intro was confusing. So just a couple -- Rob Wertheimer, Melius Research. Just a couple questions on your comments on vapes, I just wanted to understand the timeframe a bit, the ability to sort of buy in biomass and tailor or recombine, is that a statement that applies in the near term to 4Q, 1Q, 2Q kind of thing or would that take longer to do? And then maybe just commenting on the timeframe on differentiated devices in the same vein?

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

Sure. Yes, I think that certainly does apply. Assuming again this is really, let's say, all plans are contingent on how regulations develop, but assuming that we're able to have the derivative market open up, we think that there is a secondary market that's starting to develop and that there is availability. As far as -- we look at that like other -- now if you think of generally how consumer hardware works, it's really iterative. So it's not something where we're going to wait, wait years to have the end product. And it's something that we want to continually iterate and make sure that we're constantly improving. So you'll see I think multiple product lines but that is a long-term ongoing initiative where we think that the device market will become increasingly competitive and being able to iterate is going to be important. And I would contrast that with what you see in the nicotine device market. And it's important to remember that it's very difficult to launch new nicotine based devices because of the FDA restrictions and needing to apply for approval. So we think that because of using that as sort of one device being locked in, isn't necessarily going to be applicable and a good comp for how things will develop in the cannabis-based market.

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

That's very helpful, thank you. And if I may just a follow-up on dry flower, is it the same kind of timeframe as you get into more harvest coming out in 4Q or shortly thereafter. Market's been in shortage. Maybe there's less of a shortage by then who knows. Are you confident that you have the



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customer base and shelf space for distribution, whatever you want to call it, to sell through all the increased production, is that obvious to you or will it be a competitive fight at that time?

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

It's certainly hard to predict. But I would say that 4Q we think we're still extremely confident. We do believe though that the principles of supply and demand will 100% apply to Canada, whether it's talked about or not, it is inevitable. I think our model certainly being a little more asset light and not focusing on trying to be vertically integrated does rely on the assumption that supply will catch up with demand and we do expect that competition. As that continues to happen in the flower category, one of the things that we would expect will happen in terms of differentiation is understanding, how to still change format. So being able to have unique pre-rolls and make sure that you have some brand element being able to work on standardization and consistency there and genetics will really be, I think, what wins. We're also seeing a lot of the brand selection right now based off of strain, which again supports the importance of genetics. So it's really a long way of saying in the short-term, absolutely. But there is demand and there is still a shortage but there's been a lot of capital, that's important, there is A lot of planned projects and we do think that it will become competitive, but it's contingent upon execution across the industry, which is always hard to predict.

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

Thanks so much.

Operator

Your next question comes from the line of Ryan Tomkins with Jefferies. Your line is now open.

Ryan Tomkins

Yes, I was just looking to ask a little bit around the derivatives side of things. I know it's been asked about but in terms of actual facilities or processes, I'm just on that whether Israel would be up and running, and contributing to any sort of products that may be on the market come October or whether that will be after that? Thanks very much.

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

I think there is a number of different products that will be released, and we wouldn't expect the full suite to be something that's released Q4. I think a lot of the formats we're still trying to understand what the final regulations will be in terms of packaging specifically for edibles. So we do still have facility space that is allocated that will allow us to enter certain categories, but as we see the market and regulations develop, we expect to be able to continue adding to the product line.

Ryan Tomkins

Okay. Thank you.

Operator

Your next question comes from the line of Shayne Laidlaw with Hedgeye Risk Management. Your line is now open.



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Shayne Laidlaw

Hey, good morning guys. Thank you very much for the question. I don't mean to beat a dead horse here on the derivative products front within the Canadian market, but just want to ask kind of a follow-up question on, if you could add a little bit more color, you just mentioned you have facility space, could you add more color on kind of what additional investments from a kind of manufacturing process and machinery perspective that needs to happen and maybe if you're thinking about any specific categories that you're more focused on than others, whether it be beverages, edibles or the like, that would be very helpful?

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

Sure. So to be more direct, I think you could expect us to in the early days prioritize vaporizers first. I think that the regulations around vaporizers are we feel that those are much more likely to stay the way that they are today versus sort of iterate and change over time. Edibles for us it's really about understanding what those final regulations are and how we launch products, and specifically in what categories. Outside of Canada and thinking longer term, you'll see it in a lot of different categories of oral ingestibles. I'd also say topical is an area that we're focused on even sooner than just the research we're doing on skin in Israel. But Canada specifically, the regulations at least were proposed were different than what we've seen and we've been able to pull data from the US, packaging sizes, how that affects pricing overall demand. So before we put a significant amount of capital investment into unique packaging automation, we want to make sure that we know what the final regulations are, so that we're not taking up space and commissioning equipment that is for single-serve packaging only to find a few months later that that changes over to something that we're more used to in terms of multi-pack. But again, prioritizing vape we feel there's more certainty and continuing to have a platform technology that allows us to move quickly and be flexible as we see the edible regulations publishes is what we're working on.

Shayne Laidlaw

Okay, thank you for that. And then just moving to Ginkgo Bioworks and biosynthesis more broadly, and if there's any kind of color you can share on progress being made there? And also thinking about kind of the broader market and how biosynthesis is, the space in general is being more talked about, I think more accepted over time kind of versus last summer where no one was really thinking, it was like a viable solution longer term. So, if you could just talk about kind of how that space has evolved, and your mindset from a competitive standpoint and if you have any color on the progress at Ginkgo, that would be helpful? Thank you.

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

Yes. So, I think of all the initiatives we have, we still continue to be extremely bullish about the partnership and working closely with Ginkgo. We won't go into specific details on the technical milestones we've hit. You can see the R&D payments in the financials. We've been hitting milestones and continue to be extremely impressed, and with what Ginkgo has been able to do, how quickly they're able to do it, and generally just the breadth and depth of their platform. As far as competition and things heating up, I can say that we again feel very fortunate that we were sort of looking at this very early compared to the competitive set and we're able to have our first choice of partner. It's really not a surprise. I think that if you looked back a few years, people thought of biosynthesis as futuristic Star Trek-like idea, where, oh, it'll happen in five or 10 years, and we'll figure it out. And I think now the entire cannabis industry is accelerating, and people are starting to look for how will cannabis be disrupted, not just how will cannabis disrupt other industries. And as that happens, companies start turning towards biosynthesis. So it does in some ways validate thesis. We feel that we have a very strong advantage with Ginkgo being by far and away the leader in synthetic biology. So overall confident, but we do expect that this space will increasingly have focus as the science is more and more understood.

Shayne Laidlaw

Great. Thanks very much.

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Operator

We have no further question at this time. I will now turn the call back to the presenters.

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

Thank you everyone, and have a good morning.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. Have a wonderful day.

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