

09-May-2024

Cronos Group, Inc. (CRON.CA)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Britney Morgan, and I will be your conference operator today. I would like to welcome everyone to Cronos Group's 2024 First Quarter Earnings Conference Call. Today's call is being recorded. At this time, I would like to turn the call over to Shayne Laidlaw, Investor Relations. Please go ahead.

Shayne Laidlaw

Head-Investor Relations, Cronos Group, Inc.

Thank you, Britney. And thank you for joining us today to review Cronos' 2024 first quarter financial and business performance. Today I am joined by our Chairman, President and CEO Mike Gorenstein and our CFO, James Holm. Cronos issued a news release announcing our financial results this morning, which is filed on our EDGAR and SEDAR profile. This information and the prepared remarks will also be posted on our website under Investor Relations.

Before I turn the call over to Mike, let me remind you that we may make forward-looking statements and refer to non-GAAP financial measures during this call. These forward-looking statements are based on management's current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements.

Factors that could cause actual results to differ materially from expectations are detailed in our earnings materials and our SEC filings that are available on our website, by which any forward-looking statements made during this call are qualified in their entirety. Information about non-GAAP financial measures, including reconciliations to US GAAP can also be found in our earnings materials that are available on our website.

Lastly, we will be making statements regarding market share information throughout this conference call. Unless otherwise stated, all market share data is provided by Hifyre. 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' Chairman, President and CEO, Mike Gorenstein.

Michael Ryan Gorenstein

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

Thank you, Shayne. And good morning, everyone. Our year is off to a strong start, marked by 30% year-over-year revenue growth, fueled by market share gains in Canada and a rebound in sales in Israel. Gross margin improvement and operating expense reductions from fully realizing the savings implemented in 2023 as we are well on our way to achieving incremental savings of \$5 million to \$10 million in 2024. The team's consistent and relentless focus on delivering top line growth while simultaneously driving operational efficiency has positioned Cronos for success in 2024 and beyond.

I want to take a moment to discuss the cannabis market and our brand positioning. A lot of the cannabis market today is characterized by products that were launched to appeal to as many consumers as possible based on price rather than building a strong connection with the targeted segment of consumers. Without building a strong connection with consumers through a targeted approach, we see many brands lose share to more focused offerings. With Spinach, we were very intentional to target specific consumer needs and believe that was instrumental to our success. This strategy drove our success in cementing Spinach as the number two brand in Canada.

We launched Spinach in Canada at the end of 2018, and since then, the team has worked hard to bring thoughtful innovations to market across different categories. I'm so proud of the team and what we've achieved. And we leveraged that success of Spinach as a blueprint for a broader portfolio starting with Lord Jones.

We returned Lord Jones to its adult-use roots and brought it to Canada to attack product categories with a more narrow premium focus where we think brand share will be stickier and borderless. Since launching with hash infused pre-roll in Q4 2023 we expanded the portfolio in Q1 to also include Chocolate Fusions and live resin vapes that have done well in the early days following the launch.

We continue to expand the reach of our leading international brand, PEACE NATURALS. Utilizing our best-in-class genetics and high quality cultivation, we have brought strains such as Wedding Cake and GMO Cookies to Israel, Germany, Australia and now the UK.

Utilizing the PEACE NATURALS brand in new markets we enter, we continue to cement our flower products as leaders in the market and lay the groundwork for when regulations allow us to launch borderless products such as edibles and vapes.

Let's dive into how our brands are performing in the market. Our strength in Spinach extends across various product categories, notably in flower, edibles and vapes where we are in top three share positions. We've seen exceptional performance with our top products, such as our GMO Cookies flower, SOURZ by Spinach edibles and new flavor-forward 1.2 gram vapes, driving significant market traction.

In Q1 Spinach continued its strength in the dried flower category remaining the number one brand with 6.5% retail sales. This success is driven by years of genetic breeding, investment in R&D, including tissue culture, and best-in-class cultivation at scale with our JV Cronos GrowCo. In the quarter, we launched new flower strains and formats, including ASG in 28 grams and Alien Kush in 3.5 grams and we continue to develop new strains to bring to market, which capitalize on this lead.

We also launched a new brand specifically for the Quebec market called Sonique, which will feature high quality flower products to meet consumer demand for this market. In the edibles category Spinach had 14.4% market share in Q1. Our focus on developing innovative strategies and products in this category have been instrumental in the success.

The key addition to our product lineup is the Fully Blasted SOURZ, a high potency one pack 10 milligram THC gummy, which garnered early momentum in Q1 and we are encouraged by early sales to-date. With non-compliant edibles coming off the market again and the introduction of our competitive one pack 10 milligram gummy, we are confident we are bringing the right products to market.

Beyond our Spinach brand, we launched Lord Jones Chocolate Fusions, a bite size chocolate featuring a dynamic multi-texture experience. We believe our Chocolate Fusions will be a category defining product and are looking forward to getting it into more retail locations over the coming months.

In the vape category, Spinach maintained its number three market position but gained share sequentially now capturing 7.6% of retail sales in the category. Our new and improved Spinach 1.2 gram vape has received positive feedback, further solidifying our market presence and growth in this category. We also launched two new Spinach all-in-one vapes, Pineapple Paradise and Blueberry Dynamite.

Under the Lord Jones umbrella, we launched Lord Jones live resin vapes in two different hardware options in January. The lineup features versatile sizes, including a 0.5 gram trial size in the convenience of a very sleek all-in-one device and the 1-gram stock-up size as a 510-thread cartridge, catering to enthusiasts and those new to the category.

We are focused on driving market share in the pre-roll category and continue to do extensive product development and R&D work in this area. We've launched several new flavor forward infused pre-roll offerings under the Spinach brand as well as a multi-pack.

The Spinach fully charged party pack is a combination of infused pre-rolls at 40% plus THC, which includes the finest cold-filtered cannabis extract and kief coating. Our hash infused pre-roll under the Lord Jones brand has become a fan favorite and my personal favorite product. Our continued focus is to be leaders in all categories we operate in and that remains the north star for our efforts in the pre-roll category.

Turning our attention to international markets. Our operations in Israel rebounded well from Q4, which was impacted by the war. And Q1 was the highest revenue quarter in Israel since Q4 of 2022. The team in Israel has done a ton of work to refine their processes and approach to the market, which has yielded both higher volumes and improved average selling prices sequentially. Our strength in Israel is also driven by our GMO and Wedding Cake genetics, which were developed in-house and have propelled the PEACE NATURALS brand to be a leader in the markets it enters.

In April, we appointed Adam Wagner as SVP, Head of Cronos Israel, where he was previously the VP of Finance. Adam brings significant finance and operational experience across both public and private companies to this leadership position. We're already seeing a positive impact from his leadership and look forward to his stewardship of the business. We are confident that our team's approach to the Israeli market is as good as ever, and I believe that with their leadership we will continue to refine and improve over time.

We're particularly excited about our growth potential in Germany, where recent legislative changes have fueled material incremental growth in the market and have allowed for opportunities to responsibly market medical

cannabis products, which was not permitted under previous regulations. We are committed to delivering high quality cannabis products and nurturing our relationship with our partner, Cansativa.

We're also excited to announce another international milestone earlier this week with our first shipment to the UK medical market. We intend to establish our PEACE NATURALS brand as the top medical brand for patients in the UK as we've done in Israel and Germany.

International revenue can be lumpy from quarter-to-quarter, so although we did not have revenue in Q1 in Germany or Australia following our initial load in, we are very pleased with the in-market sell-through in the quarter. We are confident about the trajectory of our international revenue in 2024, underscoring our commitment to global expansion and revenue diversification.

Our joint venture GrowCo continues to excel, demonstrating robust performance in line with our expectations. GrowCo reported to us preliminary unaudited revenue of approximately \$5.1 million from non-Cronos customers in the first quarter. Additionally, the credit facility that Cronos previously provided GrowCo currently has \$67.1 million outstanding following the principal repayment of \$1.2 million in Q1. In addition, GrowCo made interest payments of \$1.4 million in Q1. The solid financial performance of GrowCo, yielding equity pickup, interest payments and the loan payback to Cronos is a vital component of our overall financial picture.

Turning to the US, last week the media reported that the DEA plans to follow the HHS' recommendation to reschedule cannabis to Schedule III. Proposal which still need to be reviewed by the White House Office of Management and Budget, would not legalize cannabis federally for adult-use but is a dramatic shift in how the plant would be classified. We think incremental progress is great for the industry and this is a step in the right direction.

This quarter's successes have resulted from our steadfast focus on building a portfolio of borderless products with strategic infrastructure and global partnerships. Our long-term strategy to invest in brand innovation that target specific consumer needs while remaining asset light is working, and we're off to a tremendous start for our 2024 fiscal year. The combination of these efforts and industry leading balance sheet sets us up well to grow in our current market and execute in any new market we decide to enter.

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

James Holm

Chief Financial Officer, Cronos Group, Inc.

Thanks, Mike. Good morning, everyone. I will now review our first quarter 2024 results in relation to the prior year period. The company reported consolidated net revenue of \$25.3 million, a 30% increase from the prior year period. Constant currency consolidated net revenue increased by 31% to \$25.5 million. The revenue increase is primarily driven by higher cannabis flower extract sales in Canada and higher cannabis flower sales in Israel.

Gross profit in the first quarter was \$4.5 million, equating to an 18% gross margin, representing a \$1.5 million improvement in gross profit and a 270-basis-point improvement in gross margin from the prior year period. The increase is primarily driven by higher sales in cannabis flower extract in Canada and higher cannabis flower sales in Israel.

The improvement in top line was coupled with numerous supply chain efficiencies such as favorable labor and overhead costs, as well as lower inventory variances, all culminating to drive a material improvement in gross margin from Q4 2023.

Consolidated adjusted EBITDA in the first quarter was negative \$10.7 million, representing a \$5 million improvement from the prior year period. The improvement was primarily driven by a decline in general and administrative and research and development expenses and an improvement in gross profit.

Following last year's overachievement in savings, we are well on our way to achieving our 2024 goal of saving an incremental \$5 million to \$10 million. In addition to delivering on operational efficiencies and maximizing the return on our cash, we received an interest payment on our GrowCo senior secured loan of approximately \$1.4 million and a principal repayment of approximately \$1.2 million for total cash paid by GrowCo to Cronos of approximately \$2.7 million in Q1. Having the best balance sheet in the cannabis industry enables us to take calculated strategic bets while we remain steadfastly focused on reducing cash burn.

Turning to the balance sheet, the company ended the quarter with approximately \$855 million in cash and cash equivalents. Moving to the cash flow statement, cash flow from operations was negative approximately \$2.2 million. This compares to the negative approximately \$47.7 million in the prior year period, which included a cash outflow of approximately \$33 million associated with the Altria warrant relinquishment.

And free cash flow defined as operating cash flow less CapEx was negative \$4.2 million. This compares to a negative approximately \$48.5 million in the prior year period. So a significant improvement. We have many wins to point to this quarter. Market share gains, OpEx reduction, balance sheet and cash flow optimization and we are reaffirming our guidance that we anticipate the net change in cash defined as the sum of cash and cash equivalents and short term investments will be positive in 2024.

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

With that, I'll open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will conduct the question-and-answer session. [Operator Instructions] Our first question comes from the line of John Zamparo with CIBC. Your line is now open.

John Zamparo

Analyst, CIBC World Markets, Inc.

Q

Thank you. Good morning. I wanted to start on the rescheduling news and I think I know the answer here, but I want to ask it anyway. Let's say we fast forward to call it November and we do get a formal rescheduling, everything's been approved. I wonder all other things equal, what does that change for the Cronos Group?

Michael Ryan Gorenstein

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

A

Good morning, and thanks, John. I think it's certainly very exciting and a great step in the right direction. But rescheduling is a very broad idea and I think the devil will be in the details. So there'll be a lot of potential opportunities and restrictions. There's a lot of plans that we look at, but I think we really need to see the details before we comment on exactly how we will pursue a US strategy under any potential new framework.

John Zamparo

Analyst, CIBC World Markets, Inc.

Q

Okay. Fair enough. And then moving back to Canada, we've seen softer growth industry-wide year-to-date. That doesn't seem to impact your brands. I wonder what you attribute the industry slowdown to be though. Obviously, pricing is a component here, but do you get a sense there's ongoing trade down from consumers? Because this has always been an extremely price competitive and price sensitive industry. I wonder how the industry can provide more value and how does that influence your strategy?

Michael Ryan Gorenstein

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

A

Sure. So, for our brand specifically, we continue to see growth. And I think what's key is, now we sort of reached a point where you're not seeing significant price compression, at least in flower, it's really bringing new products, bringing a superior quality to market and you are competing with the illicit market.

So going back to the prepared remarks, I think it's about taking the consumer segments and developing something that's narrowly focused on delivering what their needs are. So, that's something that we'll continue to do, it's something we'll continue to focus on, and you'll see whether Spinach or Lord Jones continuing to develop great products. And I think that's what will drive our growth.

John Zamparo

Analyst, CIBC World Markets, Inc.

Q

Thank you very much. I'll pass it on.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Matt Bottomley with Canaccord Genuity. Your line is now open.

Matt Bottomley

Analyst, Canaccord Genuity Corp.

Q

Good morning, everyone. Thanks for the comments so far. Just want to stay in the Canadian market. A lot of us track the retail trends and as John was mentioning, some of the slowing that we're seeing in the space, but I'm wondering if you can comment more on what your experience is in the last three months or so with respect to the provincial wholesalers. There's been a lot of – especially from some of the leading LPs, a lot of hopeful thinking of, and maybe it'll come to fruition of the IRS – or sorry, I'm in my US mode, the CRA sort of coming back and really calling some of these old excise tax payables that might lower the amount of saturation in the space. Are you seeing any tangible change with the competitive profile when you're putting purchase orders in from the provinces or do you think that's a longer term trend?

Michael Ryan Gorenstein

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

A

Sure. So I think that the CRA sort of garnered some of the payments from LPs that aren't paying CRA tax – or paying excess taxes is a step in the right direction and really does help level the playing field, but certainly I think more action is needed.

It's hard to know exactly what's driving some of the trends you see, I'd say supply is starting to dry up, but I think maybe what's bigger than the CRA is likely that you've got reduced supply from all the facility shutdowns we've seen over the last few years.

And then also, I think there is increased international demand and that is probably starting to pull some product as well. So, as you can see we've definitely experienced growth, but I think there's a lot of factors driving that and the CRA would only be one of them.

Matt Bottomley

Analyst, Canaccord Genuity Corp.

Q

Okay. Understood. And then just another question for me outside of Canada on the international front. Obviously, it's nothing new for any producer in Canada that exports internationally. There's a bulkiness to when product sort of ebbs and flows. You've had some pretty big swings in Israel and I understand some of the dynamics that are going on there. But is there any forward looking commentary you can give with respect to maybe as a percentage of your overall revenues on a 12-month basis forward, what international might look like compared to what it's been historically?

Michael Ryan Gorenstein

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

A

Sure. I want to hold back on giving guidance on percentages. I'll just say that, I think Israel will be less – won't be for us because the way that we report Israel versus others, because it's a core market for us. We have sales, manufacturing and we're really reporting sell-through. So it's different than say, the UK, Australia or Germany. But I will say that we expect significant growth in Germany given the regulatory change in the market we're extremely excited about and I think that UK does have a lot of potential to grow in the back half of the year.

Matt Bottomley

Analyst, Canaccord Genuity Corp.

Q

Okay. Thanks a lot, Mike.

Operator: Thank you so much for that. [Operator Instructions] All right. I am showing no further questions at this time. Thank you for your participation at today's conference. This does conclude the program. You may now disconnect.

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