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PRESENTATION

Operator

Good morning. My name is Catherine, and I'll be your conference operator today. I would now like to welcome everyone to Cronos Group's 2021 Third Quarter Earnings Conference Call. Today's call is being recorded.

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

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

Thank you, Catherine, and thank you for joining us today to review Cronos Group's 2021 third quarter financial and business performance. Today, I am joined by our President and CEO, Kurt Schmidt; our CFO, Bob Madore, and our Executive Chairman, Mike Gorenstein. Cronos Group issued a news release announcing these financial results this morning, which are filed on our EDGAR and SEDAR profiles. This information as well as the prepared remarks will also be posted on our website under Investor Relations.

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

I want to stress that this call will be limited to third quarter 2021 earnings and the restatement of our second quarter financial statements, and we will not be addressing or taking questions on full year 2021 results. Full year 2021 results will be discussed after we file our annual report on Form 10-K with the SEC.

In addition, during this call, certain financial measures may be discussed that are not recognized under the U.S. generally accepted accounting principles referred to by the Securities and Exchange Commission as non-GAAP measures. We believe these non-GAAP measures assist management in planning, forecasting and evaluating business and financial performance, including allocating resources. Reconciliations of these non-GAAP measures to their most comparable reported GAAP measures are included in our earnings press release furnished to the SEC, which is available on the Press Room section of our website to cronosgroup.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 will move into a question-and-answer session.

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

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

Thank you, Shayne, and good morning, everyone. I want to thank our employees, Board of Directors and shareholders for their support and patience as we work through completing our Q2 restatement and our Q3 filings. A special thanks to our finance and legal teams for putting in the extra effort over the past few months. These situations are never easy but it's essential to learn and grow from them. We are committed to continuous improvement and have learned and evolved from this situation.

Now I'd like to review recent developments related to our financial reporting and internal controls and the remediation actions we are taking, while Bob will take you through more details on these items shortly. As we noted in November 2021, the Audit Committee of the company's Board of Directors worked with our independent financial auditors to conduct a review to evaluate the goodwill and indefinite-lived intangible assets in the U.S. reporting unit for impairment. As a result of this review, we have recorded impairment charges on the U.S. reporting unit totaling $236.1 million with respect to goodwill and indefinite-lived intangible assets and on long-lived assets in the 3 months ended June 30, 2021.

Accordingly, the company has restated the period's financial statements to reflect this new information. The restatement has no impact on cash and cash equivalents or revenues. We take these matters seriously. And in connection with the restatement, we commenced making changes to our internal control policies and procedures to further strengthen internal controls related to financial reporting.

We are also undertaking a realignment of the business that we believe will best position Cronos to drive profitable and sustainable growth over time. I view the realignment in 3 distinct pillars. First, we have realigned the organization to better enable our go-forward strategy. This includes centralizing functions under common leadership, allowing us to distribute more resources more efficiently, improve strategic alignment and eliminate duplicative roles and costs.

Second, we will reduce complexity, leading to a decrease in fixed expenses. We are undergoing an evaluation of our global supply chain to become leaner and increase our ability to adapt quickly to the changing landscape. We are performing product reviews, pricing optimization and pursuing distribution that matches our go-forward strategy across North America. We are steadfastly focused on aligning department priorities and team structure to support these initiatives.

Finally, we will implement an operating expense target to help us optimize our cash deployment. As more states legalize cannabis in the U.S., we are eager to build off our investment in PharmaCann to bring adult-use THC products and brands to U.S. consumers upon federal legalization. We have set the foundation for our entry through the strategic investment in PharmaCann, and we are gaining invaluable experience through our existing businesses in Canada and other international markets. With our new organizational structure, we will be ideally positioned to enter and deliver.

The overall strategic realignment initiative is expected to deliver $20 million to $25 million in initially identified savings across operating expense categories in 2022, primarily driven by savings in sales and marketing, general and administrative and research and development.

As part of the first pillar of our realignment to centralize decision-making under common leadership, Cronos appointed Jeff Jacobson to the position of Senior Vice President, Head of Growth. Mr. Jacobson previously served as the company's General Manager of Canada and Europe. Mr. Jacobson has been with Cronos Group since December 2016 and previous to that was a Co-Founder of Peace Naturals. Mr. Jacobson's expertise and experience in licensing and compliance, new business development, project management and resource management will help Cronos Group lead in domestic and international markets.

The company also appointed John Griese to the position of Senior Vice President, Head of Operations. Mr Griese joined Cronos Group in August 2021 as the Vice President of Operations. Mr. Griese has worked with several cannabis organization and was most recently the Chief Operating Officer for the Supreme Cannabis Company.

Prior to Supreme, Mr. Griese garnered cannabis experience during California's adult-use implementation as COO for global cannabis company, Creso Pharma Limited. Prior to that, he spent the majority of his career in supply chain and operations with PepsiCo, Nestle and Sofina Foods. Mr. Griese's experience in building supply chains around the world will help the company win in the markets we are in today while staying nimble in order to move fast and pivot as the industry changes over time.

I'm confident these realignment efforts will better position Cronos to continue to assemble a portfolio of best-in-class brands and intellectual property, while preserving the financial flexibility to make additional strategic investments in our R&D pipeline and brands as we continue to innovate and evolve with our consumers' wants and needs.

Our future structure will be a brand-centered organization with teams focused on accelerating growth on the core, margin-accretive innovation, winning in rare cannabinoids, U.S. adult-use market entry and streamlining the organization to make better decisions while increasing alignment and agility.

There is a lot to look forward to as this process unfolds, and we will be providing updates in the coming quarters. In the meantime, we remain focused on driving the initiatives forward advancing our core business priorities and preparing for our entry into the U.S. While we are confident our realignment strategy will improve certain areas of the business, I believe Cronos is sitting in a great position within the global cannabis landscape, which is a credit to Mike Gorenstein's prudent leadership in the early days of legalization in Canada and the evolving landscape across the world.

From the very beginning, Cronos has taken a different approach. Instead of aiming for a multiple unfunded capacity, we stayed relatively lean and focused on R&D while creating cultivation partnerships with large-scale agricultural specialists. Instead of controlling positions in countries outside of the U.S., Canada and Israel, we chose low capital-intensive partnerships to create exposure while limiting risk. Instead of the desire to be first to market, we focused on differentiation and delivering products that consumers didn't know where possible. While this approach was not the most popular and requires patience from our shareholders, partners and employees, we are beginning to see it pay off.

The success we are seeing is proven in point-of-sale data. Our SOURZ by Spinach edibles achieved double-digit market share in the gummies category in Canada within 6 months of launching. And our breeding and genetics program has yielded some of the best-selling high-THC flower SKUs on the market in Canada.

We weren't first to achieve these rankings. But once we pushed GO on these product launches, we proved the muscle we have across our organization and the desire to win. We have looked and continue to look at the Canadian adult-use market as a test-and-learn market. We all know why it's not the easiest market to operate in, but we are focused on making it work for us. That means focusing on limiting losses with an eye towards profitability, but most importantly, creating products through extensive R&D that develops turnkey solutions for any market we operate in.

Cronos is not without its challenges, and it's had missteps. We're aware of that, and we're working to address them with this strategic realignment. But at the same time, we have a lot of confidence given we have one of the strongest balance sheets in the industry and strength across our organization, which I believe makes Cronos poised to be a leader in any market we operate.

Now getting into updates on some of the items that are working today. In October 2021, we launched the first cannabis edible in Canada to feature cultured CBG Spinach FEELZ Chill Bliss 2:1 THC|CBG gummy. Following this successful launch, in January 2022, we launched a 1-gram THC vape pen featuring cultured CBG, further extending our leadership position and bringing high-quality rare cultured cannabinoids to the market.

Subsequent to the third quarter, we hit the equity milestone for cultured CBGVA, which is a crucial step to developing cultured THCV. We're very proud of the work we are accomplishing with Ginkgo, and how we are positioning the company to win with rare cannabinoids. The Spinach brands new platform, Spinach FEELZ, will deliver a variety of cannabis products, which will primarily feature rare cannabinoids made using our proprietary processes designed to provide unique and enhanced experience.

As a reminder, Cronos believes that the best way to sustainably win in cannabis is to compete with differentiated products rather than just competing on price. We feel we've done a great job executing that strategy with our flagship adult-use brand Spinach, by delivering consumers better products and providing great overall value, and we're just getting started.

As part of the second pillar of our strategic alignment, we are conducting product and brand reviews across our portfolio, and we've decided to stop selling the COVE brand in Canada. Over the last year, we have increased our focus on growing Spinach across categories. We believe we have something exceptional with the Spinach brand that will be transferable across borders when the time comes. There may be opportunities in the future for additional brands to enter the adult-use cannabis market in Canada and different price tiers. But for now, we are focusing on our highest ROI brand, Spinach.

We also want to provide an update on Cronos GrowCo. During the third quarter of 2021, we started to purchase biomass produced at GrowCo for our Canadian operation. Cronos has always maintained that working with experts in large-scale agriculture is a strategic way to build an efficient supply chain. Seeing early successes from GrowCo has proven our instincts correct, and we're happy to see our vision for this partnership come to life.

In Israel, our medical business continues to perform incredibly well, posting another quarter of strong top line growth. We're proud of what we have accomplished in this market and establishing the relationships with patients and distributing to nearly all pharmacies that carry medical cannabis. According to a recent survey published by Cannabis Magazine, our PEACE NATURALS brand was the most recognized brand in the Israeli medical cannabis market, a true testament to the team's efforts in Israel.

As of December 2021, the cannabis patient count in Israel is approximately 109,000, which is up 40% versus the same period last year. We believe this market is still in the early innings of growth, which gives Cronos a great opportunity to continue to grow our PEACE NATURALS brand with medical consumers in Israel.

Turning to the U.S. segment. Jeff Jacobson in his role as Head of Growth is digging into the business with his team, all of whom were critical components to the success we have experienced in Canada. Jeff is leading the charge on a full portfolio view, will likely include pricing optimization, SKU rationalization and pursuing distribution that matches our go-forward strategy. Jeff and team have had a lot of great products to work with in our U.S. CBD portfolio. As we advance, we will be focused on driving future innovation towards products that better align with our desire to be an adult-use cannabis company with a keen focus on doing fewer things better and a strict mandate on return on investment. We don't expect this recovery to happen in a straight line, but we look forward to sharing the evolution with you over time.

As we realign the organization to match our go-forward strategy, the primary focus of our energy will be towards elevating our brands by utilizing rare cannabinoids and focusing on adult-use products. We have a lot of work ahead of us, but I feel confident in the actions we are taking to improve our business.

With that, I would like to welcome Bob Madore to his first earnings call as Cronos' Group new CFO. Bob, please take it away.

Robert L. Madore - *Cronos Group Inc. - CFO*

Thanks, Kurt, and good morning, everyone. As Shayne indicated in his opening remarks, my discussion is limited to results in the third quarter of 2021 and the restatement of our second quarter financial statements. I will not be addressing or taking questions on our full year results for 2021.

Before getting into the financial results for the third quarter of 2021, allow me to talk about the impairment charges and restatement of the second quarter of 2021 that we announced today. The company has restated its second quarter of 2021 financial statements to reflect a total of $236.1 million impairment charge with respect to goodwill and indefinite-lived intangible assets and on long-lived assets in the U.S. reporting unit. This restatement is noncash in nature, so therefore, does not impact cash, cash equivalents or revenues.

We are taking action to improve internal policies and procedures and strengthen internal controls. These efforts include bolstering the talent across our finance organization to help implement stronger internal controls, Kurt and I are leading the reinforcement of company policies and procedures;

making enhancements to our sub-certification process and clawback policy to drive additional accountability and expanding training programs for our finance personnel. We take these matters very seriously, as Kurt and I walked you through, and we're committed to taking action.

Now turning to the third quarter of 2021 results. The company reported consolidated net revenue in the third quarter of 2021 of $20.4 million, an 80% increase from the prior year period. Revenue growth year-over-year was primarily driven by the continued growth in the adult-use Canadian cannabis market, increased sales in the Israeli medical market and increased sales in the U.S. segment. Consolidated gross profit for the third quarter of 2021 was negative $0.7 million, representing a $0.8 million improvement from the third quarter of 2020. The improvement versus the prior year was primarily driven by an increase in sales of cannabis extracts in the Canadian market, which carries a higher gross profit than other product categories.

I'll dig into this line item a bit more on a segment-by-segment basis shortly given different dynamics are driving the respective businesses. Adjusted EBITDA for the third quarter of 2021 was negative $46.8 million, representing a $16.7 million decline from the third quarter of 2020. The decline year-over-year was primarily driven by an increase in general and administrative expenses, driven by a $13.2 million increase in allowance for expected credit losses, an increase in sales and marketing spend, primarily due to brand development in the U.S. segment and an increase in R&D driven by spending on product development and developing cannabinoid intellectual property.

Turning to our reporting segments. In the rest of the world segment, we reported net revenue in the third quarter of 2021 of $18.3 million, an 88% increase from the prior year period. Revenue growth year-over-year was primarily driven by growth in both the adult-use flower and extract categories in Canada and sales in the Israeli medical cannabis market. Gross profit for the rest of the world segment in the third quarter of 2021 was $0.6 million, representing a $2.8 million increase from the third quarter of 2020. The increase versus prior year was primarily driven by an increase in sales of cannabis extracts in the Canadian market, which carries a higher gross profit than other product categories. We've experienced some price compression in certain categories such as vape, where differentiation is a bit harder to achieve. While we were more insulated to those dynamics in certain flower SKUs and edibles, given our superior product quality and differentiation.

We are happy with our progress on gross profit and believe the realignment that Kurt spoke to will further enable Cronos Group to improve the trajectory of this line item across our businesses and regions over time.

Adjusted EBITDA in the rest of the world segment for the third quarter of 2021 was negative $29.8 million, representing a $15.4 million decline from the third quarter of 2020. The decline year-over-year was primarily driven by an increase in G&A expenses primarily due to an increase in the allowance for expected credit losses of $13.2 million, as previously discussed. As well as increases to headcount, an increase in R&D spending and an increase in sales and marketing expenses.

Turning to the U.S. segment. We reported net revenue in the third quarter of 2021 of $2.1 million, a 28% increase from the prior year period. Revenue growth year-over-year was primarily driven by the introduction of new CBD products. As Kurt noted, the U.S. CBD business is not where we want it to be. Jeff Jacobson and his team are in the early stage of realigning this business strategy.

Gross profit in the U.S. segment for the third quarter of 2021 was negative $1.3 million representing a $2.0 million decline from the third quarter of 2020. The decline year-over-year was primarily due to increased inventory valuation adjustments and increased production costs. Adjusted EBITDA in the U.S. segment for the third quarter of 2021 was negative $12.2 million, representing a $6.5 million decline from the third quarter of 2020. The decline year-over-year was primarily driven by an increase in sales and marketing costs related to brand development and an increase in general and administrative expenses.

Now turning to our cost savings initiatives. As Kurt mentioned, we've initiated a strategic realignment which is expected to deliver $20 million to $25 million in initially identified savings across operating expense categories in 2022 primarily driven by savings in sales and marketing, general and administrative and research and development costs.

Our realignment is focused on rightsizing the cost structure to be more aligned with our go-forward plans. We are focused on the highest ROI opportunities further ingraining the mentality of doing fewer things better. As part of our internal analysis, we took special care to ensure cost reductions would not inhibit growth. So you'll see continued investment in revenue-generating activities, while going forward, operating expenses will aim for a more direct tie to a percentage of revenue.

Turning to the balance sheet. The company ended the quarter with approximately $1 billion in cash and short-term investments, which is down approximately $60 million from the second quarter of 2021. Capital expenditures for the quarter were $2.5 million with the spending focused across our global strategic priorities. Capital expenditures are down approximately 70% year-over-year driven by reduced spending on enterprise resource planning implementation and capital improvements across our facilities. We remain committed to deploying capital in a disciplined manner and only in ways that align with our strategic priorities.

With that, I'll turn it back to Kurt.

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

Thank you, Bob. The strategic realignment that we've begun to implement is a company-wide initiative across every function we are identifying opportunities to reduce duplication and centralize capability, making us more efficient and cost effective as an organization. These changes are centered on a focused return to doing fewer things better. We remain committed to bringing best-in-class adult-use cannabis products to market using rare cannabinoids as a core differentiator.

While we work through the realignment, we are focused on not losing sight of what is working today, continuing to elevate the Spinach brand and expand its leading market position in Canada and bringing high-quality medical cannabis under the PEACE NATURALS brand to Israeli medical patients remain our top priorities. I look forward to all the new things we have planned from a brand and product perspective across our global portfolio in '22 and beyond.

With that, I'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from John Zamparo with CIBC.

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

I wanted to start on the strategic realignments, and in particular, you mentioned a reduction in R&D expenses. I wonder how you think about this because it seems like R&D is pretty central to the strategy both in biosynthesis but also just generally creating differentiated products. So is it -- you think that much of your arm work is already done? Or is there some other element to this? I'd just like to better understand that part of the strategic update, please.

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

Yes. This is Kurt. It's really about focusing the R&D on those categories and segments of the business that really, really drive performance. And I mentioned 2 of those areas. One is margin-accretive innovation, really focusing on adult-use cannabis products that we believe can drive that. SOURZ is a great example on the edible side. And the other area is winning in rare cannabinoids. We remain extremely focused, and a lot of our efforts is focused on bringing these kind of differentiators to market.

There's always efficiencies to be had in any function, including R&D. But as we shift more towards the adult-use segment, we feel that we'll be fully armed to really drive the innovation that we're planning over the next few years.

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

Okay. And my follow-up is on the margin structure. And I'd like to understand what it is you're trying to achieve here? Because you exceed double sales in rest of world and you are seeing some margin expansion. It's still negative, but I would think if you can keep growing sales at or close to that pace, you get some pretty good torque from that line item. But is part of the strategic review to make the cost structure more variable? And Cronos has never struck me as a company that needs to be a manufacturer. But do you want to make the cost structure more variable and outsource more of your production, particularly in Canada?

Robert L. Madore - *Cronos Group Inc. - CFO*

Yes, John, this is Bob. Thanks for that question. Yes, obviously, we're very focused on growing sales, but one of the -- not changes, but deeper focus is pursuing innovation opportunities and product categories and products that really grow sales profitably. The other thing, and it's a big focus of the strategic realignment that Kurt spent a lot of time talking about is really the evaluation of our supply chain and really making us just not more agile but more cost competitive, and we've got a number of things that we're evaluating and looking at in that regard. And I think rest of the world is an example in this quarter. Having a positive gross margin is a testimony to our focus on that. And really having some early wins in that category in addition to just some revenue mix shifts that drive improved gross margin.

The other aspect of the realignment is really just looking at our cost structure, scaling it back to where we really are today with the business and where our growth plans are. And just being more strategic with where we invest our dollars, whether it's in R&D, as Kurt kind of answered your question, or sales and marketing and G&A. So it's a multipronged initiative and strategic alignment plan that is very focused on really having impacts across the entire P&L.

Operator

Our next question comes from Rahul Sarugaser with Raymond James.

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

So I'll focus on the top line. So you mentioned that the U.S. has been a little disappointing. We've seen the U.S. market sort of take longer than many people had anticipated. So focusing on Canada, we've seen relatively good escalations in terms of market share in edibles, primarily driven by based on your differentiated products. But recognizing that the market, however, is still primarily flower. How should we be thinking about Cronos' market share gains going forward, both in terms of its organic growth, given the differentiated fermentation drive products? But also into sort of more traditional flower-based products?

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

Yes. Rahul, let me start off by saying flower is still a big part of the business, and it's still performing incredibly well for us in Canada. It's up over 90% in the quarter. And that's really driven and focused by concentrating on THC strengths, unique genetics, which we've been very successful at.

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

Okay. Great. And then just a quick follow-up. Now focusing on the fermentation-derived products. Again, we have seen rapid market share gains in Canada with that. How should we think about global expansion of those of the fermentation-derived products?

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

I mean that's ahead of us. I mean, we've only hit the 2 molecules out of the 8 that we're planning to go. We still want to build it. Remember, Canada is a test market. We're building up this brand in Canada. Once we round out the portfolio and early days are fantastic on our first edible, as I said in the script. Then everything is ahead of us, right? But we're still in the early days of developing it. But certainly, that, as we said about Canada, it's our test market, it sets the platform for our brand to go forward in other markets.

Operator

And our next question comes from Andrew Carter with Stifel.

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

First question is with the delayed 10-Q filing, I would assume filing the 10-K is on track for March. So my question around all that is are there any kind of regulatory restrictions resulting from this? Will you still be able to issue equity for acquisitions or are you in the penalty box? Just help us out on that first.

Robert L. Madore - *Cronos Group Inc. - CFO*

Yes. There are no regulatory restrictions other than management sees trade order associated with our delayed filings that we're now on time with as of today. And we foresee no delays associated with our ability to file our 10-K on time.

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

Great. Second question I wanted to ask, and I understand the Cronos story. It's using Canada as a test market for future opportunities, particularly the U.S. I guess with the cost savings, the expense target and now the kind of realignment, can you be profitable or at least near breakeven cash flow with the market opportunities currently in hand Canada adult-use medical, Israeli medical as well as kind of some of the opportunistic global medical markets?

Robert L. Madore - *Cronos Group Inc. - CFO*

Yes, I'll take that one and Kurt, if you want to add some color at the end from my response. But listen, we're very focused, and a big focus of the strategic realignment is really continuing to drive the rest of the world segment to profitability, right? And we were very encouraged by the results of this quarter and what we're seeing thus far. And it's a huge focus of that.

As Kurt pointed out, Canada is more of a test-and-learn market. And with the current market dynamics, it's a challenging market to be profitable. But at the very least, and we're very encouraged by the progress to date and what we foresee in the very near future, we definitely have the ability to be more profitable than we are today. The other great thing is with our innovative pipeline that we have, we not only are dominating flower, and we've got 3 of the top 10 strands out there at the end of the day.

But we're very, very excited about the growth and market share growth that we've experienced in other categories such as vapes, such as edibles. We demonstrated our ability to grow categories beyond just flower, and we're going to continue to expand on that. The cannabis extracts part of the business also enjoys a higher gross margin, which is only going to further benefit the profitability profile of Canada. But that's very much in the crosshairs of our realignment strategy that Kurt kind of explained.

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

Yes, we have great brands, and we're showing that we can drive those brands and that makes me very optimistic about Canada.

Operator

Thank you. And that's all the time we have for questions. This concludes today's conference call, and thank you for participating. You may now disconnect.
