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CRON - Q2 2019 Cronos Group Inc Earnings Call

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CORPORATE PARTICIPANTS

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

Jerry Barbato *Cronos Group Inc. - CFO*

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

CONFERENCE CALL PARTICIPANTS

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

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

Jesse Pytlak *Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research*

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

Michael Lavery

Tamy Chen *BMO Capital Markets Equity Research - Analyst*

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

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

PRESENTATION

Operator

Good morning. My name is Sadie and I will be your conference operator today. I would like to welcome everyone to the Cronos Group's Second Quarter and First Half 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, Sadie. And thank you for joining us today to review Cronos Group's second quarter and first half 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 all 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 obligations 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'll 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 second quarter, we continue to strengthen Cronos Group's foundation for growth and success in both the near term and long term. We made strides on key initiatives which will help us capitalize on the significant opportunities in the global cannabis industry for the benefit of our shareholders, partners, employees and consumers. I'll go into more details on each of these shortly. But since our last call, we have acquired a state-of-the-art GMP compliant fermentation and manufacturing facility in Winnipeg, hired a Chief Innovation Officer with over 35 years of CPG experience, announced our entrance into the U.S. market through a leading hemp-derived CBD platform and continued our supply chain expansion by securing third party cannabis concentrates and co-manufacturing capabilities for our derivative product launch.

For those listening who may be unfamiliar with Cronos history, I like to start each call by briefly reviewing the 4 key aspects of our strategy. At Cronos Group, we are establishing an efficient global supply chain. We are developing a diversified global sales and distribution network. We're creating a disruptive intellectual property, and we are growing a portfolio of iconic brands and products that resonate with consumers. You may notice that we use new terminology to describe the first pillar of our strategy, and going forward, we will refer to our global production footprint as global supply chain.

We have often discussed our view that in the mature market, capacity is a means to an end, not the key driver of value. Now we understand that many investors [are modelling] cannabis companies, half of their production capacity. However, our business model is not to be the former. We think that there will be value created across many verticals in the cannabis industry, and we see tremendous opportunity, but recognize it, we can't be all things to all people. Rather, we will focus on areas where we see long-term sustainable value, like research and development and marketing innovative branded products, while partnering with experts in the other verticals. This focused approach has proven successful in analogous industries such as consumer package goods and pharmaceuticals, and we think it will prove successful in the cannabis industry as well.

We firmly believe that the best way to create value to the supply chain is by working with contract farmers and suppliers to support our capacity needs. We have structured a supply chain with a cultivation asset light approach, and asset Cronos Group up for future growth by creating a global network of co-manufacturing joint ventures with first class operating partners in order to meet the company's demands. But as supply comes online, we're also excited to work with third party producers of cannabis and cannabis-derived products to supplement our own production and drive supply chain efficiencies.

We recently secured cannabis concentrate supply and co-manufacturing services agreements in Canada, which will support the launch of new products into the Canadian derivative market later this fall. These third party suppliers and co-packers, we utilize unique and proprietary formulations developed by Cronos Group for the co-manufacturing of our different products and brands. As the industry develops and matures, we plan to continue to engage third party contractors to provide us a specialized high quality services and inputs.

As our strategy evolves and progresses, so does that with some of our holdings. Cronos Australia is going to be taking a similar scalable approach by transitioning from cultivation to importing range of Peace Naturals products for sale in the Australian medical market. Cronos Australia is in the process of obtaining all necessary import permits. As we continue to diversify our supply chain, we have acquired a state-of-the-art GMP compliant fermentation and manufacturing facility in Canada from Apotex, which is one of Canada's largest generic pharmaceutical companies.

Cronos Fermentation includes fully equipped laboratories covering microbiology, organic and analytical chemistry, quality control and method development as well as 2 large scale microbial fermentation production areas. While the transaction has already closed, we are currently applying for applicable licenses and expect to hire the talented team there in the fourth quarter, while they finish winding down certain Apotex manufacturing activities. This [advanced set] facility is expected to provide the fermentation and manufacturing capabilities that we need to capitalize on the progress underway with Ginkgo Bioworks.

Last September, we launched our landmark R&D partnership with Ginkgo focused on producing cultured cannabinoids at commercial scale. This not only includes THC and CBD, but also rare cannabinoids that are economically impractical or near impossible to produce at high purity and scale through traditional cultivation. We believe our landmark R&D partnership with Ginkgo has a potential to disrupt the industry. Together with Ginkgo, we are bringing innovation and the power of biological manufacturing to the cannabis industry, which is expected to allow for efficient cannabinoid production at large scale compared to the current traditional cultivation and extraction model.



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We continue to be pleased with our progress in the potentially industry disruptive initiative. And we feel that Cronos fermentation will allow us to accelerate that progress by optimizing the cannabinoid fermentation manufacturing process in advance of a commercial scale rollout. Ginkgo is an important facet to our expanding IP portfolio. And last month, we had the pleasure of appointing Dr. Todd Abraham as Cronos Group's Chief Innovation Officer. Dr. Abraham will play a key role in overseeing our research and development initiatives, and will focus on identifying new disruptive technologies and adopting best practices and innovations from adjacent industries.

Dr. Abraham is a consumer goods industry veteran having worked in senior positions from leading global companies, such as Mondelez, Pillsbury and Procter & Gamble. He brings to Cronos Group extensive experience in identifying, developing and commercializing breakthrough technology for consumer goods. I believe Todd's strategic business experience coupled with his skills in R&D, nutritional science, strategy and organizational development will accelerate our own growth as a global leader in cannabinoid innovation. At Cronos, we believe that edibles will be an important and attractive category in a long term, and Todd's track record of successfully developing and launching a range of functional food products will be key to driving our success in that category.

This quarter, we also launched Cronos Device Labs, an impressive R&D facility to accelerate our development of device technology. Cronos Device Labs has focused on supporting the development of next generation vaporizer products. We know the vaporizer's [phase] 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 cannabinoids in a consistent and controlled manner.

This initiative is expected to significantly enhance our technology and development capabilities, and will support us in our upcoming launch into the vaporizer category. As the products we can offer consumers in Canada evolve, we will continue to expand our distribution footprint in the Canadian market. With upcoming changes in Canadian regulations which will allow for cannabis derivative products, we are excited to be launching into the vaporizer category later this year.

The regulations created for derivative products in Canada, combined with our consumer insight data that we have from the U.S. for this category, and our capabilities with Cronos Device Labs makes a launch [end of the] space a natural choice for us, as we look to offer Canadians additional consumption methods and products. We're looking forward to launching vape products across Canada, which have been designed to responsibly meet demand and most importantly, ensuring the consumer safety and quality, our top priority.

We are equally excited to announce our entrance into the U.S. markets through a leading hemp-derived CBD platform. Last week, Cronos announced that we have agreed to acquire 4 operating subsidiaries of Redwood Holding Group based in L.A. for approximately \$300 million. Redwood manufactures, markets and distributes hemp-derived CBD infused skincare and other consumer products. These products are sold online and through premium retail and hospitality partner channels under the Lord Jones brand.

Redwood was co-founded by Rob Rosenheck and Cindy Capobianco who have built a differentiated best-in-class platform of hemp-based CBD formulations that stand for quality and consistency. They have developed a pipeline of brands and products that we hope to launch in scale in the future along with the Lord Jones brand. Following the close of the transaction, it would join Cronos Group and continue to lead the development of the Redwood platform with the support of the current team and brand names. Our goal is to preserve the integrity of all that Rob and Cindy have created, while also learning from them and leveraging Cronos's resources to capitalize in the significant demand for skincare and other consumer products derived from hemp.

We're excited to be looking at the hemp-derived U.S. market with the assistance of our strategic partner Altria. As previously announced, Altria's investment ensures we have the right strategic partner in our corner as we grow and push our business forward globally. We're already capping expertise as Altria has developed in innovation and engineering and plan to leverage Altria's manufacturing, brand building and distribution capabilities in support of the U.S. hemp-derived product opportunity.

We believe 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 that what we're building will continue to resonate with consumers and will generate long-term shareholder value.



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

Jerry Barbato - Cronos Group Inc. - CFO

Thanks, Mike, and good morning everyone. Both our press release and MD&A includes comparisons of our financials to the same period in 2018. As we shared last quarter, we believe the best way to evaluate our business and the industry is the comparison on a sequential quarter basis as comparisons to the prior year do not reflect the current operating or regulatory environment. I will focus the majority of my comments discussing the second quarter's performance versus that of the first quarter of 2019.

We continue to focus on measures that highlight the operating performance of the business, including adjusted EBITDA, net revenue, kilograms sold, average selling price and gross profit before fair value adjustments. Adjusted EBITDA removes the impact 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 out press release.

Turning to Q2 results, the company reported net revenue of \$10.2 million in the second quarter of 2019, a 58% increase from the first quarter. This increase is primarily due to increased sales in CBD oil, which carries no excise tax and increased sales of dried flower. The company reported an adjusted EBITDA loss of \$17.8 million in the second quarter of 2019. The loss increased by 99% from the first quarter, as we continue to invest in the infrastructure and capabilities to support future growth.

The increased investments are primarily due to higher operating costs, namely sales and marketing, R&D and salaries and related hiring costs, partially offset by an increase in net revenue. As we continue to invest in our business, our brands and R&D initiatives, we believe our adjusted EBITDA loss will increase in the second half of the year compared to the first half. We believe the investments we are making today will position the company for accelerated growth in the future.

Turning to operating performance metrics. Kilograms of cannabis sold increased 43% to 1,584 kilograms in the second quarter of 2019 from the first quarter, primarily due to more production rooms coming online in Q4 and Q1, which was ultimately sold in Q2. As of the second quarter, all of our flower rooms at the Peace Naturals campus are fully licensed. We expect the momentum for quarter-over-quarter revenue growth to build in the second half of the year as we ramp up production in our facilities and increase third-party purchases. We continue to balance meeting demand today with focusing on the long-term strategy of our business with an asset light approach.

Average selling price for the second quarter of 2019 increased 12% to \$6.44 from the first quarter, primarily driven by a favorable mix of pre-rolls and CBD products, which carry no excise tax. Gross profit before fair value adjustments, which excludes the non-cash share value adjustments associated with biological assets and inventory was \$5.5 million for the second quarter of 2019, an increase of 57% from the first quarter driven primarily by sales growth. Unit cost of goods sold increased by 12% to \$3.01 in the second quarter of 2019 from the first quarter, largely driven by higher profits in cost as we ramp production across Peace Naturals.

Operating expenses for the second quarter of 2019 totaled \$26.3 million representing an increase of 89% from the first quarter. This increase is primarily driven by higher R&D expenses, higher professional fees for services in connection with various strategic initiatives, and higher G&A expenses tied to increased headcount and marketing spending in preparation for the upcoming derivative market launch. For example, on the R&D side, Cronos continues to invest in the research to produce cultured cannabinoids through our partnership with Ginkgo. And on the marketing side, we have started partnering with various age-gated adult events and festivals, and engaged in agency of record in connection with our adult-use brands and upcoming launch in the derivative market.

Additionally, Cronos continues to invest in its organization by increasing staffing levels across all functions. For example, in the last quarter alone, we hired over 70 new employees representing a 23% growth rate from the first quarter of 2019. We're excited for the talent we brought in as we build the organizational capabilities for a long-term success. On a reported basis, the company reported a decrease in net income from the first quarter primarily due to the change in fair value of the financial derivative liability associated with Altria's investment, which is described in more detail in the MD&A and the financial statements.



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In the second quarter, Cronos Group recorded a non-cash gain of \$264 million related to the change in fair value of these financial derivative liabilities compared to a non-cash gain of \$436 million in the first quarter. Cronos continues to expect there may be significant reported earnings volatility, primarily driven by the fair value quarterly adjustments related to the movement of Cronos Group's stock price.

Turning to the balance sheet, the company ended the quarter with approximately \$2.3 billion in cash in short-term investments. We remain focused on scaling the business for future success and continue to evaluate external growth opportunities to deploy our capital that makes sense for our business and are aligned with our strategic priorities. As we have done in the past, we will invest behind opportunities in a disciplined and balanced manner to drive long-term growth.

Capital expenditures for the first half of the year were \$28.5 million, and we expect to exceed that amount in the second half as we continue to scale the business. This spending includes investments in production capacity at Peace Naturals Cronos Fermentation in our Israeli facility, vaporizer innovation at Cronos Device Labs and the upcoming launch of derivative products in Canada, as well as the launch and expansion of CBD products in the United States.

I'd like to wrap up with two of my top priorities. Now that I've been in the CFO role for a few months, I have a couple of key initiatives that I would like to highlight for the finance procurement and human resource departments that I oversee. First, we need to have an ERP system that can support a global business in an ever changing industry. This system will connect our global operations and ensure that our practices remain consistent across geographies and operating units. Further, the system will streamline our financial reporting process, which will continue to strengthen our controls. We are currently evaluating potential solutions and plan to begin the process of implementing an upgraded ERP system in the near term.

Second and most importantly, I'm focused on our people. This includes hiring talented individuals with experiences in a broad set of industries and diverse background who can join our team and have a meaningful impact on the company's growth. We're actively recruiting every day, and our entire management team is united in the belief that our people are and will remain the backbone of our success. We're also focused on building, training and development programs to provide our current employees the skills they will need to succeed as the company continues to grow.

Overall, we are pleased with the results from the second quarter and the first half of the year, but also know, we have plenty of work to do to take advantage of the tremendous opportunity we have to become a leader in the global cannabis industry. We remain fully committed to leadership in the industry with responsible and reasonable regulation and intend to invest to achieve it.

With that, I'll turn it over to Mike for closing remarks before Q&A.

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

Thanks, Jerry. In closing, we accomplished a lot to drive the business forward in the second quarter and have taken many steps to build our competencies across a range of product formats. We started the first half of the year by strengthening our capabilities in vaporizers with the addition of Cronos Device Labs and pre-rolls with Altria's assistance. In the second quarter, we strengthened our capabilities in other value-add categories like edibles with the addition of our new Chief Innovation Officer, who is an expert in food science.

Subsequent to the quarter end, we expanded our expertise by adding additional product category capabilities, which will now include skincare, cosmetics and other hemp-derived consumer products with the announced acquisition of Redwood. We're excited to continue the momentum as we set our sights on to the U.S. Our accomplishment this quarter continues to lay a strong foundation for Cronos Group and our business objectives.

Let's now open the line for questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Andrew Carter from Stifel.

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

First question is, you suggested that your revenue will continue to accelerate from here. I guess could you discuss kind of what the kind of opportunities are the supply from Peace Naturals building force coming online, but also the demands from the second wave are kind of going to come into focus? Could you kind of discuss the impediments or opportunities here?

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

Yes, so I think if Peace Naturals comes online, we'll have more production capacity. And as also we talked about, we're building a third-party supply, so we're buying from third parties, which is what's leading to the building of our inventory for the derivative launch in Q4. So I know that's been delayed a little bit by Health Canada. So we would expect that in the end of the fourth quarter and beginning of Q1, you'll see a larger launch in these derivative product markets.

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

Okay. And then kind of the second point to that, kind of now that we know what the kind of the Health Canada guidance will be for the second wave market. What is your outlook for the sub segments overall? Obviously, Cronos is making a big commitment to the vapor category. How quick do you think approvals will happen and you'll have products on the shelf, you just mentioned end of year, but what are kind of the risks of any delays or anything like that?

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

Yes. For us, I think we're most excited about the vaporizer category, but believe that as regulations evolve and we get clarity that edibles and topicals will also be very important categories. Because of the timing of the 60 days being in December, there certainly could be a push between falling in late in Q4 versus the beginning of Q1. It's always tough to predict, but we don't expect any big delays. Certainly, a week or two could push it though, between the quarters. But overall, we think we should see accelerated demand as derivative products come online. I think it's also easier to differentiate as you get into further categories where device technology starts to play a key role in marketing. So we're very excited for 2.0 to start.

Operator

Our next question is from Tamy Chen from BMO capital Markets.

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

First question is on the guidance you gave for adjusted EBITDA over the rest of this year. I'm just wondering, I just want to get a better understanding, given that Cronos has a more asset-light model, and you've got some contract manufacturing, for example, with Heritage on the vaporizers side. I'm just wondering, like what are the key areas that you do need to rush it and increase this spending on that would weigh on your adjusted EBITDA?

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

Yes. So I think we talked about in our prepared remarks, it's really the investments behind the R&D and the increased headcounts to prepare ourselves for future growth, as well as, as we prepare for these derivative product launches is really our increase in marketing spend.

Tamy Chen - BMO Capital Markets Equity Research - Analyst

So you expecting that on the marketing side, there will be more flexibility in terms of regulation, so you'll be able to increase your marketing opportunities for the value-add products?

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

I think when we look at marketing spend and regulations, as a company, we continue to grow. It's not just focused on opportunities in Canada. So we think there's more flexibility for marketing in the U.S. or in other markets for CBD-based products. And so while we do think there is still some opportunity for marketing in Canada, we think that other countries will certainly contribute to the opportunities that we're seeing for building brands.

Tamy Chen - BMO Capital Markets Equity Research - Analyst

Got it. And my follow up as, on the B4 facility, in terms of the processing, so everything post-harvest between the drawing, the packaging, et cetera, for existing products, primarily the dry flour and the pre-rolls. I'm just wondering, has the processing capacity at the facility, is that ramping up concurrently to be able to handle and take on all the harvests that are eventually going to come from B4 or could that potentially still remain a bit of a bottleneck, despite ramp on cultivation?

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

No, I think that's certainly ramping up. And I think one of the things we talked about as an existing category, but we actually think of something where it's a big opportunity, and we're putting a lot of resources towards in R&D's pre-rolls. So there is significant expertise that we have from Altria, and we do see that as something that will rapidly increase throughput in a value-add category that -- while it exists today, we think the formats and the consistency and quality will be able to provide will be different than what's on the market right now.

Operator

Next we have John Zamparo from CIBC.

John Zamparo - CIBC Capital Markets, Research Division - Associate

I wanted to ask about the Redwood deal, maybe a 2-part question. First, can you talk about your priorities in terms of expanding the point of distribution and is that a brand you take to Canada or Europe? And then secondly, is there any plan to have that brand interact with the research you're doing the Technion or are those meant to be a standalone assets?

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

Sure, it's a great question. I think first for Redwood, I mean we would highlight that Lord Jones is the first of a pipeline of brands that we've been able to review the brand architecture and we're very excited about. And I think the different brands will have different points of distributions. We're looking at much different consumer need states that are being addressed in different occasions. So we do see Lord Jones as something where the distribution channels will continue to expand, but staying in similar retail outlets, like Sephora, SoulCycle, a lot of great opportunities for continuing



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to build that community. We're very, very excited about everything that Rob and Cindy had built there, and looking forward to continuing to help them advance their mission globally.

It's too early speculating on specific markets as far as which countries we bring the brand to. We do see significant opportunity in Europe. But ultimately, whether it's 1 country or the other will just depend on what we think is best for the brand.

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

Okay, understood. And then sticking with that subject, can you talk about FDA regulations and how you're thinking those evolve in the next 6 to 12 months and how you feel your products are compliant with their requirements?

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

Yes. As you know, the CBD industry is growing, changing and evolving pretty real time. And so independent of how the landscape continues to develop, we're very confident that CBD will have a place in the industry. And really our focus is just positioning ourselves for our success as the process unfolds. We think partnering with Redwood puts our company at the forefront of many exciting opportunities. And we're committed to continuing to lead as a responsible player, and our focus will be on quality, consistency and marketing responsibly. And we think that we've got expertise that we're able to leverage that will allow us to do that, and make sure that we end up in a place where we're all very happy with the long-term sustainable industry.

Operator

Next we have Vivien Azer from Cowen and Company.

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

So very meaningful revenue beat relative to our expectations as well as consensus. And given the magnitude of that beat, I was a little bit surprised to see the inflation in terms of cost of goods sold. So I was hoping that you could expand on that a little bit and perhaps comment whether the increased sales of CBD oil that you called out was a factor in that?

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

So good question, Vivien. As we continue to optimize our production methods at Peace Naturals and source third-party biomass, we anticipate there will be some variability from quarter-over-quarter in our unit cost. And we feel that these results are best judged over a longer time horizon. We can have quarter-to-quarter variability as we are still in the process of bringing our B4 online, which is our largest facility at Peace Naturals and dialing inefficiencies, but we expect unit cost to decrease over time as we work towards, getting towards the steady state.

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

And would you be willing to put out a target in terms of what you think the right optimized cost program would look like?

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

Not at this time. One of the things to think about is as we continue to source from third parties and as we see the price come down over time, that will have the meaningful impact on our cost.



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Operator

Our next question is from Chris Carey from Bank of America, Merrill Lynch.

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

So I think your comment is well taken on focusing on the higher margin areas of the value chain for the longer term, and how you're setting up the supply chain to position for that, right. So I guess on that front, securing more third-party supply and co-packing at Canada, are you starting to see some more favorable pricing in the wholesale channel or is this just a natural evolution of your business model to have a mix of owned and outsourced capacity? And then related on the supply chain front. For U.S. CBD, right, the Lord Jones gives you that prestige channel access, but how do you think your supply chain is set up right now to capitalize on the bigger mass convenience store opportunity?

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

Sure. So first in Canada, we are see -- starting to see more favorable pricing. And given the emphasis of capital deployment in Canada has historically been around capacity, we do expect to see that accelerate. So our view and our approach is really been to make sure that in any market, we're focusing on capturing demand making sure that we build a relationship with consumer. And as that investment capacity leads to much more supply, we feel that we'll be very well positioned to optimize margins. In the U.S., we feel that we're in a very good position as far as supply chain. And similarly, we think focusing on the demand side is the priority making sure that we have the highest quality products, that we have a supply chain, that we can provide transparency and make sure that we have quality consistent products.

We feel that we have that today, but we certainly will make sure to continue optimizing costs and I would note that we have network of contract farmers, that we have a lot of R&D that we've been doing at Cronos that can help optimize that supply chain. And I think that there is kind of 2 things that we look at, continuing to build out the brand and build that community. And then also, on the other side, optimizing margins with different technologies, whether that's the work we're doing with Ginkgo with that genetic breeding or other investments in automation throughput and packaging. And while we feel like it's underappreciated and not often discussed, we do think that efficiencies and distribution and costs is a very, very important thing and an advantage it will have.

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

Okay, thanks. And then just for the follow up. The quarter showed good progress on the legacy Canada business, which is good to see and important to see, and it sounds like that trend will continue with Peace Naturals getting licensing and you're securing more supply, right. But bigger picture, right, the opportunity is so much larger than what this quarter's results would reflect, right. And so when you think about the next year and namely kind of the U.S. market with CBD and potentially even devices, how does your geographic mix from a sales standpoint look over the next 1 to 2 years?

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

Sure. I think it's probably too early to speculate on exactly how quickly the European market will unfold for CBD. So while we see a lot of opportunity and it's exciting, I don't think we have the same clarity we do as far as the Canadian market or the U.S. So that's a big initiative, but I think it's fair to estimate that the U.S. CBD market will likely be the largest contributor over the next year or two.

Operator

Next we have Graeme Kreindler from Eight Capital.



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

I just wanted to follow up in terms of the average price per gram sold steadily increased over the past couple of quarters. And tying that in with the comments before about sourcing more supply on third party, I was just curious in terms of Cronos's strategy today, it seems to be achieving premium pricing. What's gone into that and how is that expected to trend over time?

Jerry Barbato - *Cronos Group Inc. - CFO*

Yes. So I think [it used to be] really can't read a lot in the quarter-over-quarter. I know that it's increasing today, and it's really driven by product mix as well as you've seen a steady increase in CBD sales, which carry no excise tax.

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

And I think one of the things to think about, as we start getting in different products, that costs of biomass by weight isn't necessarily representative of what the actual cost and value driver is. It's really focused on cannabinoid. So one of the reasons that we think that cost can start to get tricky, if you measure it by flower is that when you think about using fermentation, where you're getting cannabinoids that aren't coming from the weight of flower, but also, just the simple example of comparing the flower that's \$1 a gram, it has 10% cannabinoid content versus flower that's \$2 a gram, but has 30% cannabinoid content. The actual input costs into derivative products is more favorable on the latter, even though the price per gram of biomass is actually higher than the former.

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

Okay. And just as a follow up to that and with respect to fermentation. You mentioned that the fermentation facility has some activities that are going to be winding down towards the end of the fourth quarter, but is there any sort of target at this point in time in terms of when that might go operational as well as the expected CapEx budgets if you, I guess retrofitted for your need?

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

Sure. So because we need a cannabis specific license, we actually thought that it was a really great opportunity to minimize our spend, but also provide a good opportunity for Apotex. So the ability to close the transaction and apply for a license is, while the Apotex employees continue to work for Apotex and wind down opportunities, it's something that just cost savings for us and it afford them flexibility. So we thought that that was a really good way for both of us to create value. We don't have any specific targets that we're ready to discuss yet, but we do see that the most important near-term opportunity and being able to focus on what that downstream processing will be, which gives us the model to scale and optimize downstream processing. So while there's fermentation, once you actually get the fermented broth, understanding at a separate and isolated is something that we want to make sure that we develop the right technical specifications for us, so that we have a model and a blueprint as we move into commercial activity.

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

Got it. And just to clarify, once the transaction is closed, there's going to be no further involvement from Apotex in that facility, is that correct?

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

Yes. So the transaction has closed. The -- we would be hiring employees that worked for Apotex, but not with Apotex Corporate. So it wouldn't be -- yes.



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Operator

Our next question is from Michael Lavery from Piper Jaffray.

Michael Lavery

Just wanted to clarify of 1 thing from question on pricing, you said you expected to improve going forward. Is that for you as a buyer or your net realized selling price [with that]? And obviously there's a mix component there versus the -- trying to get at some of what the commodity price expectations are. What do you expect for looking ahead on you as buying flower in terms of how that market looks?

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

Yes. I think as far as buying flower, we do expect that as capacity continues to increase that it will mean that we're able to source for lower prices. So I think that comment was specific to being able to get input, that we then can use ingredients in value-add products. And a lot of the investments that we're making is in being able to take that third-party product, make sure that we're sourcing the right product, making sure we're procuring some of the type quality as far as inputs, and then formulating it and standardizing to have the value-add products where we then think on the demand side, we would still have pricing power and potentially increased pricing power as we move into things like vaporizers. But we don't necessarily -- we're not referring to dried flower as a category just using flower as the input, and then the output of the actual packaged product.

Michael Lavery

No, that's helpful clarification. Thank you. And then just on vaporizers, can you give us a sense, we know obviously that Health Canada timing, but do you have a sense of how you align with that, and what we should expect in terms of pacing? And then just in terms of differentiation, can you give a little sense of what illicit trade for something like vaporizers may look like? Is there much of a market there? And how would you means how might you stand out relative to what's out there today?

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

Sure. So we're ready for whenever we're able to launch, whenever the approvals come and we expect that late December. Again, it could slip to early January depending on how many submissions going. We think early on the 2 key differentiators are going to be certainly the formulations, being able to provide something that's consistent that delivers a desired effect, and then ultimately has good flavor profile and overall experience. And I think the most important one is safety. So there's significant work that we've done on making sure that the devices are safe, that we're using the highest quality materials from a supply chain perspective, having boots on the ground to make sure that we're auditing everything that comes over.

And also, what the interaction is between the formulations and those devices, so I think that's a big differentiator, not only amongst us versus peers, but especially against the illicit market. And as far as illicit market, while we think that there is certainly robust vaporizers out there as far as quantity, we don't expect from a technology perspective, as we continue to iterate that there's likely going to be much competition in terms of innovation. We think it's more about pricing, and would probably be something that you see competition in the value category versus more mainstream and premium.

Operator

(Operator Instructions) Our first question is from Jesse Pytlak from Cormark.



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Jesse Pytlak - *Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research*

Just coming back to the commentary on the adjusted EBITDA outlook for the back half of the year. Is there any type of kind of commentary or guidance you can provide in sense of just how aggressively that will kind of change versus the first half result?

Jerry Barbato - *Cronos Group Inc. - CFO*

Yes. I think as always, this will depend on some of the market opportunities, so how things open up, but nothing specific as far as guidance targets at this time.

Jesse Pytlak - *Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research*

Okay, that's fair. And then just coming back to the fermentation facility with respect to licensing. Are there any type of unique or kind of special classes of licenses that you'd need that would be outside of the typical cannabis licenses in Canada?

Jerry Barbato - *Cronos Group Inc. - CFO*

No, it's considered a processing license. So it's actually called out in C-45. It would be similar to an extraction license.

Operator

This brings to the end of the Q&A session today's call. I will turn the call over to Mike for closing remarks.

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

Thanks everyone, and have a great day.

Operator

Ladies and gentlemen, this concludes today's conference and thank you for your participation. Have a wonderful day. You may now disconnect.

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