

Aleafia Health (Q3 2023 Earnings)

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Corporate Speakers:

- Patricia Symmes; Aleafia Health Inc.; CEO
- Matthew Sale; Aleafia Health Inc.; CFO

Participants:

- Venkata Velagapudi; Research Capital Corporation; Research Division, Analyst

PRESENTATION

Operator^ Good morning, ladies and gentlemen, and welcome to the Aleafia Health Fiscal Year 2023 Third Quarter Results Conference Call. This morning, Aleafia Health filed on SEDAR its financial statements and associated management discussion and analysis for the 3 months ended December 31, 2022.

All comments to be made on this call today should be taken with reference to and are qualified in their entirety by those documents. Today's call includes estimates and other forward-looking information from which our actual results could differ.

Please review the cautionary language in today's press release regarding various factors, assumptions and risks that could cause our actual results to differ. Furthermore, during the call, we will refer to certain non-IFRS financial measures included branded cannabis net revenue, adjusted gross margin and adjusted EBITDA.

These measures do not have any standardized meaning under IFRS, and our approach to calculating these measures may differ from that of other issuers and so these measures may not be directly comparable. Please see this quarter's MD&A on aleafiahealth.com for more information about these measures. I will now pass the call over to Aleafia Health's CEO, Tricia Symmes.

Patricia Symmes^ Thank you, and welcome, fellow shareholders. On behalf of CFO, Matt Sale and the team at Aleafia Health, we wish you a very warm welcome and hope you've had an excellent start to 2023. When we met on November 9 of last year, we said we were very proud of achieving adjusted EBITDA breakeven profitability in Q2 of fiscal year 2023, which ended on September 30, 2022, well in advance of previous estimates.

Aleafia Health continues to make strides ahead of these projections, which we'll speak to this morning. There is no question that quarter-over-quarter, the company's prospects continue to improve with an even better outlook as we move into the next fiscal year.

Today, we will tell you about our team's impressive accomplishments in this quarter and what they mean for Aleafia Health investors. Financial outperformance is the term that describes the company in Q3 fiscal year 2023. Today, reporting on Q3 fiscal year 2023, we are even more pleased to tell you that we have continued to grow profitability with the second consecutive quarter of positive adjusted EBITDA, again, well ahead of previous projections. This is a remarkable achievement.

Adjusted EBITDA was \$0.4 million, an increase of \$2.8 million over the calendar period ending December 31, 2021. The company accomplished this in part with these two initiatives, continued aggressive cost containment and accelerating growth in international partnerships. In terms of cost containment, since the previous quarter, there was a 20% further reduction in FTE and an approximately 51% reduction in quarterly adjusted SG&A over the last 4 quarters.

As we've demonstrated here, the \$3.8 million in quarterly adjusted SG&A in fiscal year Q3 was reduced from \$7.8 million in the same calendar period 1 year ago. Internationally, there was \$0.6 million in international sales for fiscal year Q3 2023, up from a negligible amount in the calendar period ending December 31, 2021.

On January 30, subsequent to the quarter's end, we announced a second European partner and during Q3, executed the first shipment to a previously announced international distributor. We will tell you more about these topics later in the presentation.

Now moving to the company's core strategic objectives. The company's 4 strategic objectives demonstrate how we are continuing to achieve growth and leadership on our path to sustainable profitability. First, we continue to target a top 10 position in our adult-use market and outlining some of the highlights in this pillar of the business.

Our run rate net revenue is now \$25 million, while trailing 12-month Adult-use net revenue experienced a 51% increase year-over-year from \$16 million in the 12 months ending December 31, 2021, to \$24.2 million in the 12 months ending December 31, 2022 period. At the same time, Divvy leadership in Ontario Value segment in both pre-rolled and mill flower has achieved number four positions, respectively.

The very successful launch of Divvy Buyers Club, a rotating product achieved a #6 ranking in Ontario's flow-through system, a newer sales model in our largest market. Divvy Buyers Club provides consumers with rotating flower product curated by our selective team and sold in an attractive 7-gram offering. With the continued national expansion, we have now entered Manitoba, our fifth provincial distribution region, enabling Divvy and the rest of the portfolio to reach over 70% of the Canadian population.

There has been a healthy 9% growth in revenue sequentially from Q2 fiscal year 2023 despite an industry-wide market retraction. All of this adds up to a number 13 ranking for market share in our core markets for Q3 2023. We firmly believe a top 10 market share ranking can happen in our next fiscal year, which begins April 1, 2023. In looking at the

other three pillars, there are very good signs of growth and scalability. In the sticky medical market, the company achieved \$13 million in run rate net revenue while continuing to penetrate key high-value markets, including veterans and third-party clinics.

We are also pleased to report a record month in November 2022, with \$1.1 million in total cannabis sales. In international sales, we now enjoy a \$2.3 million run rate net revenue and have shipped products to markets in three countries, Germany, the U.K. and Australia.

The fourth pillar is something we are truly proud of, our second consecutive quarter of adjusted EBITDA profitability. Our relentless pursuit of adjusted EBITDA profitability has been very successful, and we are dedicated to continue to make sure continues on an upward trajectory.

Now we move to the transformation of the business. We previously mentioned the term financial outperformance for Q3 fiscal year 2023 and have in previous quarterly reports, spoken to the monumental transformation of the business as we entered the adult use market with branded products and wound down our B2B bulk wholesale business. Also contributing to this improved adjusted EBITDA profitability trend was building our international sales channels and pipeline and many aggressive cost reductions for family altering the company.

The change to a branded portfolio strategy has resulted in consistent and steady growth in revenue. A clear example of this is Q4 fiscal year 2020. Branded net revenue came in at \$5.2 million, 34% net revenue total with wholesale at \$10 million. Now in Q3 fiscal year 2023, the branded cannabis net revenue was \$10 million or nearly 93% with wholesale only representing \$0.8 million.

Let's turn our attention over to Aleafia Health's performance by channel. Q2 fiscal year 2023 highlights of the adult-use channel. We have seen strong demand for the targeted on-trend Divvy brand, and it continues to drive net revenue growth. Adult-use revenue increased to \$10 million for the quarter ended December 31, 2022, up from \$9 million in the prior year, while Adult-use net revenue increased to \$6.2 million for Q3 fiscal year 2023, up from 6% for the same calendar period last year.

Entrenching successful brands will be the key to success in the adult use cannabis market, and Divvy has become a very strong brand, driving 11% growth in total revenue and 4% in net revenue over the prior year. Divvy is a success. It has become the #4 ranked pre-rolled brand in Ontario with 4.4% market share and occupies the same #4 position among milled flower products with 6.1% market share of our largest provincial consumer audience.

Divvy is a brand with impact. The Divvy brand comes in many attractive formats, enhancing its overall success. It capitalizes on popery outdoor flower with a fun and curated portfolio and high-margin product formats. There are multiple flavors and

profiles of our vapes, including popular fruit flavored and CBD versions and there are highly popular pre-rolls, milled and whole flower in different formats.

In addition, the new Divvy Buyers Club provides members with the best curated flower from trusted cultivators chosen by our team of connected cannabis connoisseurs for an exciting surprise that keeps changing. We take the same fun and generous approach with our grassroots marketing activities and PR outreach as well as continuously innovating in a strictly regulated marketplace, driving loyalty and adoption through events, merchandise and media.

Now to share with you some of our branded highlights of our flagship holiday window. For example, over the holidays in December, we staged the very first consumer-facing window display at high-traffic Yonge-Dundas Square in Toronto at a flagship licensed retail location, featuring Divvy Bogart's Kitchen product lineup.

Our (inaudible) winter window generated 7.9 million organic impressions just from natural traffic outside the home of the store during the holiday season. We also threw an in-store shopping event with a full store brand takeover for Divvy and Bogart's kitchen, generating over \$16,000 of sales for the store that night.

Adcann, a very reputable Cannabis marketing media platform featured both our whimsical Window display and the in-store shopping event. We look forward to staging other such events where permitted.

Now to speak a little bit about our Port Perry-Sun grown slower. In the Divvy portfolio, sun-grown outdoor flower is a key component to some of our best-selling products. This year, changes in grow practices in Port Perry increased usable flower for our most profitable best-selling branded products. This year's harvest brought in 18,000 kilos of flower with an average of 22% THC and over 4.7% terpene.

This fantastic harvest from Port Perry Farm will enable us to make a significant progress toward our goal of attaining a top 10 Ontario market share in the next fiscal year. As mentioned previously, mill flower and pre-rolls have reached impressive market shares in Ontario, both ranked number four in their respective segments. Consistent high-quality supply is very important to maintain and grow that market share, and the 2022 harvest will provide exactly that for Divvy.

Divvy Mill flower is now available in a new large 28-gram format, along with a CBD variety. It's currently the top mill flower brand on ocs.ca. Pre-rolled have become a much more important part of the business with a 3.1% market share in listed regions and a 69% CAGR since Q1 calendar year 2021, and there is continued pull-through of new listed formats.

Now turning now turning our focus to the medical sales channel. In a declining medical market, our formula for capturing market share means driving growth in new high-value

patient groups. The growth in our product portfolio and outreach to groups like veterans has offset industry trends and increased year-over-year growth in new markets.

Medical net revenue, excluding clinics, rose to \$2.7 million in Q3 fiscal year 2023 as compared to \$2.2 million in the same calendar period ending December 2021. This is a significant achievement in a contracting market, and that's not all. Other key achievements in Q3 include the highest medical sales month ever with a record \$1.1 million in cannabis sales in November. 12 new products introduced to patients in Q3, targeting specific patient segments with new formats and expanding our flower and edible portfolio.

Registering the highest ever number of registered veteran patients in Q3, showing our marketing strategies effectiveness in reaching this crucial customer base and investing in a new platform that demonstrated a significant increase in e-mail engagement and a reduction in overall medical marketing spend by approximately 68% per year.

Now moving our attention to the international side of our business. We believe in pursuing internal national markets to enhance margins, diversify the sales mix and unlock new untapped and growing localities. At the end of January, subsequent to the quarter's end, we signed a second European cannabis distribution partner, representing a 1-year approximately 1 million contract, significantly bolstering the company's growing international channel.

Some of the international highlights in Q3 were executing on a \$4.6 million 2-year sales commitment, shipping product that is now in the European market, completing expansion in Ontario are facilities that will now increase our growth capacity by 20% for international products.

As a result, international sales for the 2022 calendar year were \$1.7 million, up from \$0.7 million in calendar year 2021, a 155% increase despite a modest decline quarter-over-quarter. Investors will hear much more from us about our international market in the year ahead. Our CFO, Matt Sale, will now take over and present the company's financial overview. Matt?

Matthew Sale^ Thank you, Tricia. I'd now like to talk through some of the key financial highlights in Q3 of fiscal year 2023, including reaching our second consecutive quarter of adjusted EBITDA profitability. The company's key performance indicators all point toward a position of profitable growth.

Comparing the quarter ended December 31, 2022, to the same calendar period a year ago, total revenue increased by 23% to \$14.8 million from \$12 million. Total net revenue also increased by 23% to \$10.8 million from \$8.8 million. The primary driver of this growth was our branded cannabis portfolio with branded cannabis net revenue growing 20% to \$10 million from \$8.3 million.

In the Adult-use market, the largest source of the company's revenue, net revenue increased by \$0.2 million or 4% over the prior year. This was primarily due to strong pre-roll and milled flower performance. As we've explained on prior earnings calls, our whole flower sales performance was constrained by product stock outs, stemming from our Grimsby greenhouses high-THC usable flower supply being outstripped by consumer demand.

As previously announced in November, we initiated proceedings to wind down the Grimsby greenhouse for net savings of approximately \$4.1 million per year. The sales process continues with strong interest from a variety of potential end users. We continue discussions and negotiations with potential buyers and are working towards signing and closing next quarter.

The net proceeds from this sale, combined with our revolving receivables facility, which had an undrawn balance of \$6.8 million as of last Friday, are expected to be the primary sources of liquidity to fund the company's near-term growth plans.

Now that we have secured new sources of usable flower supply, we are seeing our flower sales rebound. That said, the competitive environment continues to intensify and our sales reacceleration hasn't been as strong as we had hoped. Whole flower sales have not yet returned to their peak level, which was obtained in Q1 of fiscal year 2023. Our medical net revenue increased by \$0.9 million or 40% over the prior year, predominantly driven by the integration of our 3 medical channels last summer and the positive sales momentum from our veteran and third-party clinic referral growth initiatives.

Our quarterly international net revenue of \$0.6 million was slightly down from the prior year due to the timing of export shipments. But overall, we have increased international net revenue by 155% in the 12 months ended December 31, 2022, over the prior year. This is primarily the result of a securing of \$4.6 million 2-year sales commitments in Q2 of this fiscal year.

Our gross profit margin of 37% compared to 27% in the prior year is benefiting from an increase in sales mix from international and enhanced margins in the Adult-use sales channel, resulting from the exhaustive portfolio optimization project launched in Q5 of last fiscal year, the end of March 31, 2022.

There is a notable time lag between when those SKU and brand changes are initiated and their effect in each of the provinces we sell into. We recently initiated another SKU and brand rationalization, which will see our SKUs contract by approximately 1/3. We find this prudent and necessary to continue to protect and strive to expand our gross profit margin profile.

Our adjusted EBITDA of \$0.4 million is a record dollar figure and a record margin percentage for the company since its strategic shift for the branded cannabis producer. Our growth strategy of building 3 profitable growing sales channels in the adult-use

medical and international channels, coupled with strict cost containment is delivering a continually improving profitability profile.

Over the last 4 quarters, we have identified and extracted over \$16 million in annualized cost savings in adjusted SG&A. The 51% decline in quarterly adjusted SG&A from \$7.8 million in the quarter ended December 31, 2021, to \$3.8 million in the quarter ended December 31, 2022, is a significant achievement and a testament to the company's commitment to drive out costs and build profitability. Over that time frame, adjusted SG&A as a percentage of total net revenue declined from 89% to 36% in the most recently completed period.

Some of the more notable cost rationalization initiatives include a 20% reduction in headcount quarter-over-quarter, resulting in \$2.5 million in annualized cost savings. IT enhancements, including completing the first phase of our ERP road map and consolidating certain vendor relationships to procure their goods across each of our physical facilities and utilize their services across all three of our core sales channels. Going forward, we are augmenting our vendor selection criteria to align our interest with the volume-based pricing discounts and those vendors who match our size and scale.

We are operating with the current adjusted SG&A profile that is flexible and scalable to facilitate continued net revenue growth. We continue to extract operating leverage evidenced by improving adjusted SG&A expense profile. This has been a major driver of us reaching adjusted EBITDA profitability in the last two consecutive quarters and one that we believe is actually necessary given the increasingly competitive environment in the Canadian and international cannabis marketplaces.

We achieved our second consecutive quarter of adjusted EBITDA profitability, reaching \$0.4 million in Q3 of fiscal year 2023. This performance was led by Divvy, our popular and growing everyday brand to further improve our sales performance, we're implementing further brand and SKU rationalization to put Divvy [ascent] of our efforts. Moreover, we will be deepening our strategic flower supply relationships through which we obtain high-quality whole flower from highly vetted growers for products like our Divvy Buyers Club.

Expanding our gross profit margin is also a key lever for profitability. Each new international sales order structurally improves our margin profile as these sales are typically at higher margin profiles than either the medical or Adult-use sales channels. In our adult-use business, putting large format SKUs at the center of the portfolio is key to extracting further margin in pre-roll mills and flower product categories.

As an example, the launch of refills pre-roll packs and [milk] pouches are two initiatives underway to move our portfolio towards higher-margin SKUs. Automation at our Paris processing facility and continuous grow improvements at Port Perry are also underway to augment our cost structure and drive down our variable costs.

The company remains keenly focused on adjusted EBITDA profitability as it is an important step on the pathway towards operating cash flow profitability. We are very proud to be amongst the very small public companies in our industry with similar size and scale that have achieved this significant milestone. We've been able to achieve this because of focused sales growth execution, aggressive cost rationalization and disciplined capital allocation.

In addition to top quartile adjusted EBITDA to profitability, we also maintain best-in-class growth rates. We believe these two key performance indicators in time could drive a potential rerate of our public market valuation. Here on the left side of the page, you can see that based on the company's forward course provincial markets, the company has had the highest compounded quarterly growth rate in retail sales pull-through over the last 8 quarters since the launch of the Divvy brand in Q1 of calendar year 2021.

And on the right side of the page, based on an enterprise value to 2023 net revenue trading multiple basis, you can see that Aleafia trades at a deep discount to a selection of its public market peers of similar size, scale and business focus. The strong unmet evident by top quartile profitability and best-in-class growth rates in adult-use retail sales pull-through. We believe there is an opportunity for robust shareholder returns in the quarter to come.

With three quarters of fiscal year 2023 now complete, the company has updated its full year 2023 net revenue, gross profit, adjusted SG&A and adjusted EBITDA targets for the fiscal year ending March 31, 2023. In the year-to-date, total net revenue was \$33.5 million, and gross profit margin is 31%. We have updated our full year targets to a range of between \$44 million and \$46 million for net revenue and a gross profit of between 32% and 38%.

The change in our net revenue guidance is primarily related to the previously announced OCS cybersecurity attack, BC Strike and Grimsby greenhouse production being significantly outpaced by drive forward demand. The company achieved adjusted EBITDA profitability two quarters ahead of plan, and we are now on track to outperform our fiscal year 2023 targets by a wide margin.

As a result, we have increased our adjusted EBITDA guidance from a range of between a loss of \$7.5 million and \$2.5 million to a range of between a loss of \$0.5 million and a gain of \$0.5 million. Management's strict headcount and SG&A containment efforts, competitive strength are expected to keep adjusted SG&A roughly in line with prior quarters on a percentage to total net revenue basis.

Our branded cannabis growth portfolio is working. We are a top 5 player in Ontario in both pre-roll the mills and experienced recent positive momentum in the whole flower category. Supported by these achievements and the strong fundamentals underlying our business, we are very optimistic about the company's outlook.

As we've explained on prior earnings calls, those net revenue financial targets are underpinned by our growth strategy targeting three channels, adult use, medical and international.

And we've launched many initiatives to drive net revenue growth across all these sales channels for our branded cannabis product portfolio. Based on the most recently completed quarter ended December 31, 2022, our annualized run rate net revenue was \$44 million, with branded cannabis products representing over 90% of that and bulk wholesale representing the remainder.

In the Adult-use market, we are anchoring our brand and product portfolio around Divvy and have instituted an approximately 1/3 net reduction of SKUs -- the activity surrounding Divvy is very creative and innovative and are increasingly using our other supporting brands under the Sunday Market House of brands to build awareness and pull-through of the Divvy product portfolio. In the medical channel, maintaining and building upon our top 5 market share position is our key objective.

Our online store continues to grow, offering a wide variety of both Aleafia and third-party products for our patients. Our efforts to further build patient engagement has been working, evidenced by an increase in average order value of 16% over the prior year.

And internationally, we are executing on new partnerships while we expand our European network to position ourselves for legalization there. Most recently, we signed a \$1 million sales order in January 2023, with a second partner and continue to see a robust pipeline of opportunities to bring Aleafia's products into select international markets. Trisha, over to you.

Patricia Symmes^ Thank you, Matt. Before we turn the presentation over to some Q&A, let me conclude by saying from my point of view as CEO, Aleafia has traveled a very long distance in the past 12 months. As Matt and I work closely together with our entire team to change the company's direction resulting in the report we have provided to you today.

Basically, we examined every single aspect of the company's operation. Every subject was on the table. What we concluded was that Aleafia Health had great prospects with the infrastructure to succeed, but the changes would have to be made and that they would be difficult and involved making very hard choices. In addition, a financial structure had we put in place that would sustain the company over time and provide for short- and long-term future. We have done this and more and believe profitability, our ultimate goal is within our grasp.

I am very proud of our team and what we've been able to accomplish in the first three quarters of this fiscal year. The [operen] words used in this presentation were financial outperformance and monumental transformation.

These characterize our presentation today. We have delivered more than we could promise and we have carried out those changes that have positioned Aleafia to be a growing, successful and profitable company. We said we are going to deliver results, and we did. That makes me very proud.

I became the Aleafia Health CEO 1 year ago. And every day, I am truly inspired by the serious devotion, hard work and team approach of all those who have contributed to the company's success as represented by our second consecutive quarter of adjusted EBITDA profitability. That is financial outperformance. We thank you for your support, and I look forward to meeting with you next time for our full year fiscal results. Now we will turn it over to Q&A.

QUESTIONS AND ANSWERS

Operator^ Certainly. (Operator Instructions) And our first question will come from Ven V. of Research Capital.

Venkata Velagapudi^ So I was looking at your guidance for full year. It implies almost a sequential growth 3x in a row. Usually in cannabis, June, March quarter is seasonally weaker than Q4, right? But what's exactly driving the sequential revenue growth in your Q4?

Matthew Sale^ So the implied Q4 of fiscal year 2023 net revenue would be between 10.5% and 12.5%. So at the low end of this, this will be slightly below this past fiscal quarter and at the top end of the slightly above.

We feel the vast majority of that would still come from our three core channels, being Adult-use, medical and international. And with the developments over the past for now into week six of this quarter, we think we feel good about wholesale continuing a similar trajectory, so that we can round out the year at somewhere between \$44 million and \$46 million of net revenue.

Venkata Velagapudi^ And also, I'm seeing the SG&A has consistently reduced and good stuff on exhibiting good fiscal prudence. But is there room for further decline in SG&A on your end?

Matthew Sale^ Our goal is to largely maintain roughly in line where it is today on an absolute dollar basis. We think in time as a percentage of total net revenue, that will decline, right, as our revenue grows and adjusted net SG&A. I think there's two offsetting factors. Yes, we still continue to look for efforts to reduce cost. That would be partially offset by very targeted investments in the business, particularly in the sales and marketing teams around -- centered around our Divvy brand building efforts.

Venkata Velagapudi^ Okay. Perfect. Because I'm trying to understand -- so right now, it's -- you guys are positive at adjusted EBITDA level, but I want to understand at what level will you generate this -- positive operating cash flow?

Matthew Sale^ Great question and one that's always top of mind for us. We think that's the next level in our profitability pathway is not just adjusted EBITDA profitability, but generating positive operating cash flow. As you know then, below adjusted EBITDA, some of the key adjustments there would be debt servicing costs and working capital. On the topic of working capital. It's one that we monitor very closely.

Year-over-year, we've seen in an absolute basis, our inventory be maintained on a dollar basis, but on an inventory turnover basis, we've made tremendous improvements. Similarly, we manage our accounts receivable collections very closely and have been very successful with a very low bad debt expense in this fiscal year. And so our goal -- our next -- our goal in the next fiscal year is to work towards positive operating cash flow.

Operator^ I would now like to turn the conference back to Tricia Symmes for closing remarks.

Patricia Symmes^ Excellent. Thank you. We'd like to thank all listeners and fellow shareholders for spending the morning with Matt and I and the team here. We look forward to continuing to delivering on these results as we move into the final quarter of our fiscal year and present to you our year-end. Thank you for your support in Aleafia, and we continue to deliver against our commitments. Thank you, and have a great day.

Operator^ This concludes today's conference call. Thank you for your participation. You may now disconnect.