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Valens GroWorks Corp. (VLNS.CA)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to The Valens Company's First Quarter 2020 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Everett Knight, Executive Vice President of Corporate Development and Capital Markets of The Valens Company. Please go ahead.

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

Thank you, operator. Good morning, and welcome to The Valens Company first quarter 2020 financial results conference call. A replay of this call will be archived on the Investor Relations section of the Valens' website at www.thevalenscompany.com/investors.

Before we begin, please let me remind you that, during the course of this conference call, Valens' management may make forward-looking statements. These forward-looking statements are based on current expectations that are subject to a number of risks and uncertainties that may cause actual results to differ materially from expectations. For more information on the company's risks and uncertainties related to these forward-looking statements, please consult the company's AIF, MD&A and other regulatory filings available at www.sedar.com. Any forward-looking statements should be considered in light of these factors.

Please also note that as a Safe Harbor, any outlook we present is as of today and management does not undertake any obligation to revise any forward-looking statements in the future. For a reconciliation of non-GAAP measures discussed, please consult our MD&A filed on SEDAR.

Joining me on the call today are Mr. Tyler Robson, Chief Executive Officer; Mr. Chris Buysen, Chief Financial Officer; and Mr. Jeff Fallows, President.

With that, I would now like to hand over the call to Tyler. Tyler, please go ahead.

A. Tyler Robson

Chief Executive Officer & Director, Valens GroWorks Corp.

Thank you, Everett, and welcome to everyone who has joined our earnings call to discuss our results for the first quarter for the period ended February 29, 2020. I would like to begin by sharing our utmost support and solidarity to all the listeners and their families that together we navigate these unprecedented times. To the frontline workers including those in our healthcare systems across the country and beyond, we thank you for your selfless dedication in helping us find our way through this pandemic. What we or anyone can't control is the overall impact this will have on our communities, businesses, industries and overall our society as a whole.

So we're focusing on what we can control which is our commitment to working to protect communities by assisting where we can and ensuring those who require cannabis products and services can continue to access them both safely and efficiently.

Bringing purposeful products and services to patients and consumers has been our mission since the inception of the company and is reflected in our recent rebrand which we announced in December. The end of Q1 has marked our first quarter as The Valens Company. Our rebrand represents much more than just a corporate name change. It signifies the evolution of our business into a leading cannabinoid-based product development and manufacturing company positioned to capitalize on the evolving industry on a global scale. Our rebranding reflects our growth and transformation over the past few years which culminated in us achieving a new strategic positioning with the launch of Cannabis 2.0 and accelerating the scale-up of our white label capabilities during the first quarter.

Revenue for the first quarter of 2020 increased to CAD 32 million, a significant year-over-year increase from CAD 2.2 million in the first quarter of 2019. Gross profit was CAD 18.1 million or 56.6% of revenue in the first quarter of 2020 compared to CAD 0.9 million or 38.3% of revenue in the first quarter of 2019. Adjusted EBITDA was CAD 14.3 million or 44.7% of revenue for the first quarter of 2020 compared to a negative adjusted EBITDA of CAD 2 million in the first quarter of 2019.

We are pleased with these strong results which demonstrate the continued advancement of our growth strategy amidst the challenging market backdrop. The decrease in gross profit, margin and adjusted EBITDA margin were expected as we roll out our white label program. The business segment offers greater opportunity to engage further with our customers who are looking to launch new and innovative product format, but bringing a more conservative margin profile going forward.

With that said, we're expecting aggregate EBITDA growth to accelerate with the bulk of our growth coming in fiscal Q3 and Q4 as a significant number of our new products at the shelf. We recognize that COVID-19 pandemic is evolving situation and we're currently running our business with the health and safety of our employees as a top priority. Now more than ever before, we are committed to remaining a valued and trusted partner to our customers despite the challenges we expect this market to bring.

With this in mind, we continue to leverage the flexibility of our platform to create win-win scenarios in our partnerships, manage contracted extraction volumes in month to month, and drive additional revenues through our white label program. We also recognize the urgency in preventing the transmission of the virus during this time and recognize the significant responsibility we have to ensure our communities are cared for. To help the nation-wide effort to bring COVID-19 under control, we are using our existing extraction production line capabilities to distribute products that have the potential to fight transmission of the virus and alleviate essential supply shortages.

We are bottling and donating 40,000 bottles of hand sanitizer in various formats to healthcare workers across Canada. We also have donated significant quantities of various personal protective equipment such gloves, gowns, sanitizing wipes from our existing supplies. We'll continue to do everything in our power to support those on the frontlines in the fight against COVID-19.

To our investors, I would like to reassure you that we are confident in the strength of our working relationship with our customers and our ability to service them in these difficult times. We will strive to continue to provide transparent and effective communication to all of you throughout the next several months as the situation continues to unfold.

I'll now turn the call over to Jeff Fallows, President of The Valens Company, to dive deeper into our operational achievements in this quarter and the outlook on the rest of the year as well as provide more details on how we're adapting to the current environment. I'll be available to answer questions at the end of this call.

Jeff, over to you.

Jeffrey Fallows

President, Valens GroWorks Corp.

Thanks, Tyler. The first quarter of fiscal 2020 was a pivotal point for The Valens Company. In the midst of a challenging market environment, we continue to hit many critical milestones in the strategic development of the company. We believe our efforts in this quarter will present significant revenue opportunities later this year and beyond and have greatly furthered our goal of being a leading cannabinoid-based products company delivering next generation products to our customers.

I'm going to start by recapping our achievements in the first quarter and talk about the trends we are seeing in the cannabis market before going into our outlook for the remainder of the year which will include the initiatives we've put in place to adapt to the COVID-19 pandemic and the impact we are seeing so far.

Throughout the quarter, we leveraged the flexibility of our extraction platform to help our customers navigate increasing complexity in the market while at the same time accelerating the scale-up of our while label capability. These efforts included launching a number of new product formats such as hydrocarbon-based offerings with the intention of bringing these high-demand products to customers at the beginning of the third quarter. As a result of these efforts, we now expect white label to exceed over 50% of revenues in Q3 2020, earlier than our previously expected timeline of Q4. We processed 19,962 kilograms of dried cannabis and hemp biomass in the first quarter of 2020.

In line with the trends identified on previous earnings conference calls, our processing volumes remained flat as our production mix shifted to a number of smaller lot run in order to help our customers launch a broad assortment of products into the Cannabis 2.0 market. This transition also resulted in an increase in our revenue per gram of input to CAD 1.44 per gram in the first quarter of 2020 compared to CAD 1.25 per gram in the fourth quarter of 2019 and CAD 0.61 per gram in the third quarter of 2019.

Revenue per gram is expected to continue to increase throughout 2020, as the number of white label contracts continues to grow and revenue from extraction contracts returns to growth or contributes to a smaller proportion of total revenue.

The company has 25 SKUs across 5 different product lines in its development pipeline and expects this to grow throughout 2020 to meet demand from its customers for Cannabis 2.0 products, including vape pens, edibles, concentrates, cannabis-infused beverages, topicals, tinctures and capsules.

As the industry matures not just in Canada, but globally, part of our strategy to produce differentiated, innovative and high-quality products is to acquire and develop proprietary technologies with a customized delivery of cannabinoids. During the first quarter, we extended our exclusive license for the SōRSE by Valens' emulsion technology to include Europe, Australia and Mexico in addition to Canada, representing a nearly 20 times increase in the adjustable population, exclusively available to Valens and its customers. This was followed in late February by the announcement of our first international shipments of white label products to customers in Australia. The initial shipments will consist of three SKUs of tinctures, totaling over 3,000 units, and are expected to be shipped in the coming months, pending receipt of necessary import and export permits.

During the first quarter, we also signed a multi-year extraction white label agreement with Emerald Health Therapeutics and a multi-year product supply agreement with Dynaleo. In addition to extraction services, Valens will provide Emerald Health, one of the leading players in the medical market, with white label services including formulation, mixing and filling for vaporizers, soft gels, and tinctures. We are looking forward to helping them expand their product portfolio over the course of the year. Dynaleo has agreed to purchase a minimum of 40 kilograms of THC or CBD in year one and two of their contract in either distillate or SōRSE by Valens emulsion followed by 50 kilograms and 75 kilograms in the subsequent years for use in the production.

Most recently in Q2, we launched – excuse me, most recently, we launched cannabis-infused beverages through a white label partnership with A1 Cannabis Company, a subsidiary of Iconic Brewing, which were first to market in Ontario. The demand for quality products is becoming increasingly evident in the market and we are proud to be able to differentiate ourselves with our innovative offering enabling us to capture market share and empower customer brand development in a strict regulatory environment. In particular, we believe that isolate will continue to gain traction and that future demand is currently underestimated. Our process allows for the manufacturing of very high purity of isolate which speaks to our advanced technologies and positions us well to take full advantage of this emerging market opportunity. This will lead to further development of our white label product offering for both our licensed and unlicensed CPG customers.

Now, I'd like to move on to the current market volatility and give some further color on the impacts we are seeing on our business in Q2. Like many, we are seeing challenges in the current market environment with several of our customers experience reduced workforces and temporary decreases in cultivation output which have resulted in reduced demand for extraction services. Retail demand for cannabis has surged during the COVID-19 pandemic, and while we are currently anticipating strong white label sales going into the second half of fiscal 2020, we are currently unable to predict the full impact these market challenges will have on our second quarter results.

That being said, we continue to benefit from the flexibility of our platform, the quality of our output and the experience of our team in assessing opportunities both in the near and longer term. With the breadth of new products on the horizon, a white label platform that surpasses even the largest Canadian cannabis companies, a diverse customer base and early signs of extraction volume recovery, we are well positioned to adapt to ever changing environment and consumer demand. Our strong cash position does not leave us complacent as our team looks to maximize capital allocation to generate the highest return on invested capital for our shareholders.

As Tyler mentioned, we cannot control the overall impact of the pandemic, but we can remain focused on the factors within our control. With this in mind, we are taking a five-pronged approach to navigate the current environment. First, maintaining the health and safety of our employees as paramount. Secondly, ensuring adequate supply of critical business inputs to drive production. Third, identifying, communicating and executing on business priorities. Four, eliminating or delaying all lower priority projects and expenditures. And five, opening appropriate communication channels to ensure all of our stakeholders stay informed of our progress.

In the near term, we have turned our focus to our domestic operations and have temporarily slowed our international expansion efforts as a result of the global impact of the pandemic. This focus includes getting our K2 facility in Kelowna and our Greater Toronto Area operations up and running, and continuing to further our IP development activity. While we remain confident in our balance sheet, we believe this is the correct course of action in the short term, mitigating risk, allowing us to focus on our core operation and potentially setting the stage for even more attractive investment opportunities as we emerge on the other side of the current market challenges.

I'll now turn the call over to Everett Knight, Executive Vice President of Corporate Development and Capital Markets, to discuss our CapEx plans in more detail and some of our other initiatives to bring value to our shareholders. Everett?

Everett Knight

Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

Thank you, Jeff. As our company grows, we recognize the increased responsibility we have to communicate both effectively and transparently to the investment community. Given the heightened levels of uncertainty in the market, this is now even more true than it ever was before. Our philosophy has always been and will remain to maximize return on invested capital for our shareholders. This is shown in our targeted global expansion strategy which focuses on developing distribution channels and near-term revenue opportunities with shorter payback period rather than an asset-heavy model during this period of market uncertainty.

With recent events and large stimulus packages being issued by countries around the world, we believe this may accelerate cannabis legalization as governments look for tax revenue in future quarters and years to come. Although Jeff mentioned that we temporarily slowed our global expansion efforts in this environment, we have expanded our international team and will be opportunistic for strategic undervalued assets that we can get at a discount in years to come.

With that said, we still expect the global cannabis revenue within 2020 with the potential for facilities on the ground internationally in 2021. We continue to focus largely on intellectual property, IP, related initiatives as we see an increasing attractive pipeline of opportunities that we can leverage throughout our growing global platform. From an investors' standpoint, we have hit many significant milestones in Q1 that we expect – that will help us increase the liquidity of our stock and enhance shareholder value including securing DTC eligibility for our shares traded on the OTCQX. This will bring us closer to increasing trading volume and liquidity in the United States and allowing us to reach new investors in larger markets.

We also announced a normal course issuer bid in the quarter allowing us to purchase and cancel up to 6,275,204 of Valens common shares from the open market purchases from time to time which will be funded with cash on hand. We have not yet purchased any shares under the normal course issuer bid, but intend to be more active in the coming quarters as allowed by the plan and as appropriate in the market. Most recently in Q2, we announced that we received conditional approval on March 25 to graduate from the TSX Venture to the Toronto Stock Exchange, another major milestone in our plans to bring value to our shareholders as we gain access to a wider group of investors, indexes, exchange-traded funds as well as analyst coverage opportunity. And now we are excited to announce that on April 14, we were recently granted official approval by the [ph] TMX (16:57) to up-list and we will officially start trading on the Toronto Stock Exchange this Thursday, April 16, under the ticker symbol VLNS.

Our belief is that company fundamentals including cash flow generation will be the main driver of long-term shareholder value. However, with these major milestones in place, we increased our ability to reach new sophisticated investors not only as a profitable company, but as a leader in the cannabis space. As discussed on our last conference call, we are working towards increasing our manufacturing capacity at our Pommies facility north of Toronto and we are budgeting for approximately CAD 10 million of capital expenditures at that facility.

Once complete, we will ramp white label activities for beverages, edibles, and SōRSE by Valens in the Greater Toronto Area starting at the end of fiscal 2020. The planned capital expenditures to bring the facility into full operation are fully funded with cash on hand. The K2 facility in Kelowna is on track to ramp up operations in the second half of 2020. Once this facility comes online, it will expand our 425,000 kilogram extraction input significantly and add increased scale to a number of our manufacturing capabilities in the second half of 2020.

With that, I will now turn the call over to Chris Buysen, CFO, to talk about our financial results. Chris?

Christopher Buysen

Chief Financial Officer & Director, Valens GroWorks Corp.

Thank you, Everett. Based on the operational achievements highlighted earlier in the call, consolidated revenue increased to CAD 32 million for the first quarter ended February 29, 2020, a significant increase from CAD 2.2 million in the first quarter of 2019. Revenue is comprised mainly of proprietary and industry-leading extraction and white label manufacturing services, oil and oil-based products testing for Cannabis 2.0 market and analytical testing revenue.

Revenue from the cannabis operating segment increased to CAD 31.6 million in the first quarter of 2020 compared to CAD 2.2 million in the first quarter of 2019, as the company continued to focus on processing cannabis and hemp biomass, sourcing bulk winterized and distillate oil for our partners' Cannabis 2.0 products, and scaling up the white label product formulation and manufacturing to include tinctures and vaporizers.

During the quarter, we did experience a moderation in extraction volume and frequency of shipment, which we anticipate continuing through the second quarter of 2020 as a result of the current operating environment with several of our customers experiencing reduced workforces and temporary decreases in cultivation output in response to the COVID-19 pandemic. Looking forward to the back half of fiscal 2020, we anticipate extraction volumes to begin to strengthen as additional equipment comes online including expanding our hydrocarbon capabilities. Additionally, in the first quarter of 2020, the company generated CAD 0.6 million in revenue from analytical testing through the company's ISO 17025 accredited lab including CAD 0.17 million in the intercompany revenue, a significant increase from the CAD 0.1 million in revenue in the first quarter of 2019.

With our continued revenue growth in the first quarter and timing of certain sales of oil and oil-based products [indiscernible] (20:40) for Cannabis 2.0 market, customer trade receivables increased to CAD 42.1 million at

February 29, 2020. Of these trade receivables, 67% are held with five Health Canada licensed partners of the company.

To give some additional context on our accounts receivable aging, based on the terms of the agreements with our licensed partners, we expect to collect outstanding receivables within 30 to 90 days of invoice. Subsequent to the end of the quarter, we are pleased to have already collected or have trade payables with the same partners with 54% of these receivables, which supports the already strong cash position of the company and speaks to the strength of our current relationships with our industry partners. With revenue from branded customers set to overtake licensed partner revenue later in the year, we expect revenue collection to become more stable as provincial retailers will form a larger portion of our customer base and our platform continues to become more diversified.

Consolidated gross profit increased to CAD 18.1 million or 56.6% of revenue for the first quarter of 2020 compared to CAD 0.9 million or 38.3% of revenue for the first quarter of 2019. The gross profit from cannabis operations for the first quarter was CAD 17.7 million or 56.2% compared to the CAD 0.8 million or 35.9% in the same period in fiscal 2019.

Gross profit margins for the cannabis operation were impacted in the first quarter of 2020 by a write-down of inventory for CAD 2.4 million related to cannabis purchased and processed which the cost of these two specific lots of inventory exceeded the net realizable value. Prior to this write-down in inventory, cannabis operations realized a gross margin of 63.9% of revenue in the quarter. The analytical testing operations saw an increasing gross profit for the first quarter to CAD 0.4 million or 72.3% compared to CAD 0.1 million or 69.6% in the same period from fiscal 2019.

Operating expenses for the quarter were approximately CAD 11.6 million compared to CAD 7 million in the same period in 2019. The increase from the same period in 2019 was primarily attributable to higher depreciation and amortization costs, salaries and wages, and research extraction and lab supply costs as the company scaled its operation to meet demand [indiscernible] (23:18) in 2020. These increased costs were partially offset by lower share-based payments and advertising and promotion costs in the first quarter of 2020.

Adjusted EBITDA was CAD 14.3 million or 44.7% for the first quarter of 2020 compared to the negative adjusted EBITDA of CAD 2 million in the first quarter of 2019. The company recorded a tax provision in the first quarter of CAD 0.3 million. With the continued ramp-up of profitability, one of the company's entities remain taxable after utilizing all available non-capital loss carry-forwards. The company continues to deploy strategies to effectively manage the overall tax structure of the company and review this tax structure on an ongoing basis.

For the first quarter of 2020, company posted net income of CAD 2.5 million or CAD 0.02 per share compared with a net loss of CAD 6.4 million or CAD 0.07 per share in the same period 2019. The company had CAD 44.3 million in cash and short-term investments as of February 29, 2020, compared with CAD 58.7 million at November 30, 2019.

With that, I'll now turn the call over to the operator to open the lines for the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we'll be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of David Kideckel with AltaCorp. Please proceed with your question.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Good morning. Congrats on the quarter, guys, and thanks for taking my question here. A couple of questions for you. You've mentioned both in your press release and also you've alluded to in your prepared remarks this morning while the COVID-19 pandemic brings some uncertainty to your next quarter, I'm just – and that's completely understandable, can you maybe elaborate on how you're gearing up and preparing for the uncertainty in Q2 and really being able to deliver in the next subsequent quarters of Q3 and Q4?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Sure, David. This is Jeff. I'll take this one. And just to note for the call, I'll be directing all the questions to members of the team just to make sure we're efficient, we're not talking over each other. But if you have specific people that you'd like to target your question for, please feel free to do so.

So, David, as I said in my comments – the scripted comments at the beginning of the call, the first step that we looked at in assessing what we should do in the context of the market was first and foremost make sure our employees are safe and secondly that we had all the critical business inputs and the supply lines we needed were in place to make sure we continue to operate. But the next part of that strategy was to then take a look at our plan for the year and strategize around which were the appropriate priorities in the context of what we're seeing in the market.

So at the end of Q1 and into Q2, as we said in our remarks, we started to notice that slowdown in our tolling extraction services and then decided at that point to pivot our efforts to the while label program. So you remember that we had originally anticipated that base extraction would represent the majority of our revenue for the better part of 2020. But in light of the slowdown, we ramped up activities in our white label and now believe that those efforts will pay even more dividends later in the year, and as such, the white label program will represent a larger part of our revenue much sooner than originally anticipated. And that means things like our hydrocarbon extraction, a broader portfolio of other white label products and things like bringing isolate in larger quantities to the market.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay. Thanks for that, Jeff. And just a follow-on question unrelated [ph] here. With (27:46) respect to the accounts receivable and accounts payable, we do know that they both increased in this quarter. So I'm just wondering if you can shed – and I know, Chris, you gave some color on this, but are you able to shed some more lights on that?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Yeah, Chris. Go ahead.

Christopher Buysen
Chief Financial Officer & Director, Valens GroWorks Corp.

A

Yeah, certainly. So [indiscernible] (28:03) by my remarks kind of earlier in the call and as we disclosed in our financial statements. So our receivables are comprised with 67% of them made up with our kind of five largest partners. Of that balance, 55% of that balance, we were able to subsequently receive after the quarter. You know that's a little bit lower than what we received at the end of Q4 largely just based on the timing of when we reported Q1 and we had more time obviously between the end of Q4 and when we reported our year-end results.

So as far as our overall kind of philosophy and strategy with respect to receivables, we're very proactive in how we're looking at managing those relationships on a daily basis. As part of our kind of review for the quarter, we did provide a provision of CAD 358,000. We see that currently as our exposure at this time. We have worked with a lot of our partners kind of around timing of payments and have extended some payment terms with some of our partners and, kind of through that process, haven't had any of them miss kind of any of the commitments they made with respect to the payment term obligations that we have set up. So, don't foresee any additional risk with respect to the balance of that at this time.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay. That's very helpful.

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

And David, it's Everett. It's Everett here. Just a follow-on. From an expectation on a modeling standpoint like for all of 2020, we're forecasting that every single third-party customer is under 10% of our forecasted revenue. So the diversification that Jeff talked about in the opening remarks will continue to be a strength for us going forward as well as branded products, these third-party like we have a licensed producer category and then we kind of have the branded products category where we have CPG customers like Iconic, [indiscernible] (30:15),et cetera. We continue to see a lot of demand growth on that, and if you look at our expectations and forecasts for Q3 and Q4, our branded products actually exceed in the licensed producers and were paid by the provincial retailers in that case where we get the revenue and then we actually pay a royalty back to those licensed partners.

So I think that that's way more stable of an environment and diversified into the back half, and then going forward from an AR as a percentage of sales, you're going to see that come down here significantly as we have that diversity going into the back half just for your modeling. And just to understand the provincial payment dynamics for investors, currently provinces on average pay after 60 days. So our customers get that money and then pay us, but that means that we're getting paid between 60 and 90 days for a lot of those customers and that's why the receivables are coming in at that time not, as Chris mentioned, because they're late on payments, they've been timely on those, so just for your expectations on modeling going forward.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Very helpful. Thank you for the color and I'll hop back in the queue.

Operator: Thank you. Our next question comes from the line of Neal Gilmer with Haywood Securities. Please proceed with your question.

Neal Gilmer
Analyst, Haywood Securities, Inc.

Q

Yeah, good morning, guys. Maybe want to start off with your comments on the revenue per gram. Obviously, you've had a very noticeable increase from Q3 through Q1 of this fiscal year and your comments that you expect to trend higher. Can you provide any sort of color on whether you expect the same sort of rate of growth or is that going to sort of moderate as we move through 2020?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Yeah, thanks, Neal. Maybe I'll take this one and then others can add on [ph] at the back (32:01). So it – right now, as we look forward, it's a little too early for us to really have great color on exactly where that revenue per gram is going to go. Obviously, it's going to depend on our product mix. Different products will deliver different revenue per gram dynamics. But we appreciate from an investor perspective and from an analyst perspective that you're going to need an additional color on how to forecast this and plan this going forward. And as the trends in the market and we get a better handle on how the market's developing, we fully intend to help with better guidance in that regard. But in the short term here, we're still trying to get a better handle on what products are going to be driving which demand as we move through 2020 here.

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

And Neal, just – it's Everett, maybe just to add like, I reiterate what Jeff said, it's tough to model today, but we can – you can expect with more white label products in Q3 and Q4, and as they become more of a revenue stream, naturally that dollar per gram will increase and it's just, as Jeff said, different products have a different dollar per gram. So beverages are really high dollar per gram. Others range, but as more white label come on line, we expect that to increase over time.

Neal Gilmer
Analyst, Haywood Securities, Inc.

Q

Okay. Thanks guys for that. Maybe just on the expansion in Kelowna, I think in your prepared remarks, you commented on it being complete or being operational in the second half of 2020. When that comes online, obviously increases your capacity. Does it have any change or impact on your cost structure for your operations at all?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Obviously – sorry, this is Jeff and again maybe I'll start with this one and then others can jump in. Obviously as your volume increases, your efficiency increases, and with the additional facility online, we do expect that we'll be able to run larger lots, be able to spread the production platform over a larger area and that should drive efficiencies for us. But again it will depend on in the short term what the product mix is coming out of there and how that demand sort of fills up that facility over the course of 2020.

Neal Gilmer
Analyst, Haywood Securities, Inc.

Q

Okay. Great. Thanks very much, guys.

Operator: Thank you. Our next question comes from line of Jenny Wang with Eight Capital. Please proceed with your question.

Jenny Wang
Analyst, Eight Capital

Q

Thank you. Good morning. My first question, Everett, you mentioned that you're expecting branded partners to exceed LPs in the second half of 2020 in terms of revenues. Is this under the expectation that you will find new partners versus mostly existing partners increasing their volumes?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Everett?

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

So thanks for the question, Jenny. So as far as – it's both, right? So we expect – I think you're going to see in Q2 here both our number of contracts expand as well as the existing partnerships we have. You're going to see more scale and more product growth on those platforms, so it's a two-pronged answer. We expect some on growth on both fronts.

Jenny Wang
Analyst, Eight Capital

Q

Got it. Thank you. And then just in terms of your inventory on hand, I'm just wondering what's kind of the average shelf life of the inventory and with COVID potentially creating a slowdown, are there ways to kind of expand that shelf life or to mitigate any inventory expiring?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Everett?

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

Yeah. So the inventory obviously increased this quarter that's in preparation for the Cannabis 2.0 products. We're obviously gearing up for more branded sales. [ph] We did discuss to be (35:36) more the revenue which those branded partners don't have their own dried cannabis. So we went out and prepared for that, and especially if you look at hydrocarbon, Jenny, you need specific inputs. With hydrocarbon, you need higher terpene profile in the actual cannabis itself. So it's important that we supply that now and get ready, and we're not taking on that ongoing price risk for our customers, which worked out really good in this environment now that we have adequate levels.

To kind of answer your question on the stability of the products long term, dried cannabis like – obviously it's different on how you store it, but call it three to six months, you see degradation over time. Oil and in distillate, you see way less degradation. We don't have actual studies on long term as an industry, but people have held it on hands for years. So as licensed producers in this industry, I think there's over 400,000 kilograms of dried capacity on people's balance sheets. They have to make a decision either they let that expire or they turn it into distillate and actually get longer shelf life, which is an opportunity for us as extraction volumes kind of start picking up in

Q3, Q4 and we're already seeing conversations with some of our customers where they're starting to plan for that as Cannabis 2.0 products ramp up.

Jenny Wang
Analyst, Eight Capital

Q

Got it. Thank you. I'll join back in queue.

Operator: Thank you. Our next question comes from the line of Paul Piotrowski with M Partners. Please proceed with your question.

Paul Piotrowski
Analyst, M Partners, Inc.

Q

Hey, guys. Thanks for taking my question. Just a quick point on the inventory. So, in preparation of hydrocarbon and all that heading into the back half of 2020, so are we getting normalized levels now or do you guys feel like you need more on hand?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Sorry, this is Jeff. So maybe I'll take this one. So, obviously, it's going to depend on opportunities we see for pricing of product that we're looking for and our demand profile as that continues to grow. But I would think at current levels, it should be pretty steady going for the next several quarters. But as the demand continues to grow, that certainly does have the potential to increase especially as our volumes increase.

Paul Piotrowski
Analyst, M Partners, Inc.

Q

Okay. Great. And then just a quick one on Pommies, so I don't know if I missed this, but do you have a timeline for [indiscernible] (38:05) CapEx at that facility?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Yeah, so we – as Everett said in his remarks, we're forecasting around plus or minus CAD 10 million in capital expenditures to bring the facility online and that will largely take place over 2020, next three quarters.

Paul Piotrowski
Analyst, M Partners, Inc.

Q

Okay. Great. Yeah, that's all from me. Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from line of John Chu with Desjardins Capital Markets. Please proceed with your question.

John Chu
Analyst, Desjardins Capital Markets

Q

Hi, good morning. So my first question is just on moving towards white label, you're changing the payment dynamics. You're getting paid from the provinces you said. So I'm just curious if there is any risk to what we've seen going on on the LP side where we're seeing some sales being returned – sales return provisions, price adjustments and whatnot. Are you at risk of that given that the payment is coming from the provinces now?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Maybe Tyler, we'll give you a chance to jump in here [indiscernible] (39:18) to you.

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

A

Yeah, absolutely. John, it's a loaded question because at the end of the day, we don't have a solid answer yet. We haven't seen any returned product or any issues yet, but obviously it's something we need to mitigate going forward. But at some point, I would say we will be exposed to that. But again because our products are value-added and we're really doing custom manufacturing, we're not really the ones taking the liabilities, it's the partners that are, so we're not really close to the higher end of the spectrum.

Jeffrey Fallows
President, Valens GroWorks Corp.

A

And John...

John Chu
Analyst, Desjardins Capital Markets

Q

[indiscernible] (38:51) small lots or lowers your risk as well, right?

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

A

Correct. Yeah. So we basically mitigated as much risk as we can, selling smaller losses, smaller volumes, different provinces rather than basically overburdening one province at a time and that's why we've gone strategically [indiscernible] (40:09) province and have negotiated supply agreement with them directly.

John Chu
Analyst, Desjardins Capital Markets

Q

Okay.

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Everett [indiscernible] (40:16)

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

And John...

John Chu
Analyst, Desjardins Capital Markets

Q

[indiscernible] (40:18) something or...

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

Yeah, just maybe [indiscernible] (40:19), like on the Cannabis 2.0 products side, we've seen less returns and more demand obviously even on our beverage front. Initial shipments we said were sold out in Ontario. So I think that's an encouraging sign. So for our branded partners coming online especially different companies have like there's more bankruptcies and everything else, I think there's a lot of market share up for grab for them to define themselves and it's our job obviously just to differentiate their brand and put their best foot forward into that provincial supply chain as Tyler mentioned.

John Chu
Analyst, Desjardins Capital Markets

Q

Okay. And then my second question just in terms of – you talked earlier about expanding your footprint internationally by as early as 2021. So I'm just curious what do you need to see from a market development perspective to warrant that move because we've seen a lot of LPs make the jump too early and it's obviously they've had to scale back shortly thereafter. So I'm just curious what do you need to see in a specific market to make you want to make that move and then the required investment thereafter?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Yeah. Thanks, John. I'll start with this one. So first, it's about – as Everett said in his remarks, it's about distribution. So the first conversations we have, we know what we can do. We know that we can put a Valens box anywhere and that we know what's coming out of the box in [ph] high quality (41:40) fashion. So what we need to make sure we can do is obviously sell and distribute the products in the new markets. So every market conversation starts with distribution and then we work back from there and say, okay, now we have our distribution partner, we have the opportunity, what's the right way to enter and what's the right size facility. So any international expansion we do will start small and grow in the context with the market. So there will not be any big swings, there will not be any large investments on an international perspective. It will be start low, go slow and make sure that we're able to funnel the product that want through to the right distribution channel.

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

And just to add to that, like our internal, what we look for is near-term revenue and what's the payback period. We don't view this as put an asset down and wait for the market to legalize. It's like Jeff said that revenue-first dynamic where we find distribution and then build it out accordingly to optimize that supply chain afterwards.

John Chu
Analyst, Desjardins Capital Markets

Q

Okay. Great. Thank you.

Operator: Thank you. Our next question comes from the line of Kimberly Hedlin with Canaccord. Please proceed with your question.

Kimberly Hedlin
Analyst, Canaccord Genuity Corp.

Q

Okay, thanks guys and good quarter. Most of my questions have been answered, but maybe could you comment if you're seeing any weakness in your average tolling rate?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Maybe Tyler, we'll give that one to you.

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

A

Yeah. Absolutely. At this point, we're not seeing any weakness in tolling rates. Again depending on the form factor that the products you're going for, each type of extraction has a very different payment structure whether it's CO2, ethyl alcohol or hydrocarbon. Hydrocarbon, we're actually seeing almost a fight for capacity because everyone wants to participate in that value-add service, and with our contracts, we actually created a deescalating scale based on volumes, quantity and duration of contract. So we've already built it into our expectations on tolling and the only thing I'd say is the demand for capacity in hydrocarbon is far more significant or superior than we ever thought.

Kimberly Hedlin
Analyst, Canaccord Genuity Corp.

Q

Great. And then maybe just on the SG&A side, is Q1 a good run rate that we should be looking out for the year or do you expect that to ramp up as the new facilities come on [ph] or not (43:59)?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Chris Buysen, maybe we'll turn that one to you.

Christopher Buysen
Chief Financial Officer & Director, Valens GroWorks Corp.

A

Yeah, definitely I can speak for that. I would say, on the SG&A front, I think in the short term kind of through Q2 and into early kind of Q3, I would say Q1 would be a very good indicator of what our run rate is going to be. And I think obviously as we kind of transition and expand our footprint next door, we will see some increases as we bring that facility on line into kind of the latter half of the year.

Kimberly Hedlin
Analyst, Canaccord Genuity Corp.

Q

Okay. Great. Thanks so much.

Operator: Thank you. Our next question comes from line of Robert Fagan with Stifel. Please proceed with your question.

Robert Fagan
Analyst, Stifel Nicolaus Canada, Inc.

Q

Hey, guys. Thanks for taking my questions here and congrats on a nice quarter. I just wanted to touch on the decrease in volumes that you're seeing in that quarter and spilling into Q2 and whether that's attributable in your mind to COVID or perhaps just the more gradual rollout of Cannabis 2.0 products, obviously we've seen reports of demand surging at retail for COVID-related reasons, but how is the rollout of Cannabis 2.0 going in your view like assuming it was kind of like a 10% to 15% share of market in the early months of this year and how do you see that progressing as a percentage of overall market demand this year?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

So maybe I'll take a first shot at that and then we can pass it off. But so I'd say first off, I think that it would be – we'd be oversimplifying to say that the slowdown was all related to the COVID crisis. I think if we're looking at our partners and their inventories and et cetera, in the context of this, certainly I think there will be a compounding factor in terms of – if I was then – I'd want to work through the inventory I have in the context of the current market without expending additional working capital. So I think that there is a dual effect going on there. But from a Cannabis 2.0 product perspective, we continue to think that we've only just scratched the surface on what the demand for those products will be particularly as new products are to hit the market, new form factors. I mean we saw a lot of exciting things that we have in our pipeline that we haven't even got to market yet. So we continue to think that the growth of the Cannabis 2.0 market is really [indiscernible] (46:33).

Everett Knight
Executive Vice President-Corporate Development & Capital Markets, Valens GroWorks Corp.

A

And Rob, just to expand on what Jeff said, I think with the smaller like lot sizes for the different SKUs in Cannabis 2.0, that's why we saw a moderation as well [indiscernible] (46:44). So in Q3, Q4, our expectation is more oil products are selling as the demand in the kilograms in the back half from a volume standpoint will increase again. So, obviously, the moderation is happening now, and what I'd say broadly on the Cannabis 2.0 segment, I think as more market products come on like hydrocarbon and you look at the US and you see that 50% of the market almost is oil-based Cannabis 2.0 products and we really haven't had that in Canada. And even with retail sales in January being CAD 154.2 million, so we're at a CAD 1.85 billion annualized industry, but we really haven't even scratched the surface on Cannabis 2.0 products. So you can [ph] see (47:28) as that grows, I think there's a very large opportunity for Cannabis 2.0 products to become, in our view, long term as people want those more convenient factories instead of rolling and joining in their home. They want to conveniently take out a vape pen or a customized beverage with our SōRSE technology and they want that convenience. So I think it has the opportunity to be greater than 75% of all sales down the road. So I mean that's our view and that's how we're prepared it for.

Jeffrey Fallows
President, Valens GroWorks Corp.

A

And maybe I can add just one more point, as we're looking at – I mean obviously we're excited about the opportunities we have from the while label perspective and the current market really gave us an opportunity to accelerate that program which is great, but on the base extraction side, what conversations we're having now and we're starting to have with our customers both new and existing customers is what this crisis has brought to the forefront is the need to focus on core operations and the conversation we're having with them is that the extraction services we provide may not be core to a number of those partners.

So as we look to the back half of the year, I don't want to make it seem like, we don't believe our extraction services will be in demand. We believe they will be in demand and we believe that we'll be able to continue to develop the value-added services and partners that we have, as those parties begin to focus on their core operations and we move forward. Just in the short term, we wanted to make clear and be transparent that the short-term dynamic may not play out in Q2, but we're certainly excited about the opportunity to provide those in Q3 and Q4.

Robert Fagan
Analyst, Stifel Nicolaus Canada, Inc.

Q

Okay. Great. Thanks. Thanks for that color. It sounds promising. The follow-up question is with the evolution of the [indiscernible] (49:09) shifting towards the white label category and forgive me if this is [ph] rookie (49:15) question, but how do you see your procurement prices trending alongside that with obviously probably an excess of supply in the wholesale market currently?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Tyler?

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

A

Yeah. Sorry. So the excess supply in the market, so when you really look at our platform, it's again a little convoluted. Depending on the product, we obviously – the overall price per gram go up depending on the form factors going to and the delivery system, and what a lot of people don't understand about the [ph] land (49:56) part of the Canadian cannabis sector is a lot of that product is inferior. So I truly believe that there's low volumes of quality product that we would use to basically put into our hydrocarbon lines and then that would be still sold at a premium. So the overall market doesn't really affect us as far as different types of extraction or different form factors, but obviously we would capitalize on low-grade products to bring into different form factors like this with our isolate and that's one thing I think a lot of people [indiscernible] (50:24) the overall margins on isolate once you really start talking about different form factors or different delivery system. Every CPG company we're currently talking to is in the high demand for isolate. It has the most unwanted and it has the highest potency and the longer shelf life. Our isolate also is probably the most potent in Canada, and then to be honest, I'd probably put it up against anybody in the world. So when we're really looking long term, I would say [ph] it does the shift is (50:50) the hydrocarbon and isolate. And we're not going to be affected long term by the commoditization of the low-grade cannabis.

Robert Fagan
Analyst, Stifel Nicolaus Canada, Inc.

Q

Okay, great. Thanks, guys.

Operator: Thank you. Our next question comes from the line of Rahul Sarugaser with Raymond James. Please proceed with your question.

Rahul Sarugaser
Analyst, Raymond James Ltd.

Q

Good morning, gents. Thanks so much for taking my question. Just really want to have one quick question for you. Looking at the commitments on your MD&A when you outlined that the company has commitments for hemp and cannabis biomass totaling almost CAD 75 million over the next couple of years, particularly given sort of the [indiscernible] (51:29) with COVID-19 in terms of demand, how confident are you to be able to meet those commitments over the next couple of years?

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Tyler, maybe [indiscernible] (51:40) put that one to you.

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

A

Yeah. I'm confident we can meet the demand at the end of the day, but the big thing for us is the demand is far superior than we ever expected. So when we started the company in, call it, early 2012, we didn't know hydrocarbon was going to be such a significant factor at that time. We really didn't have any trends to go off of Colorado and California at the time. So we're doing our best to scale up core platforms for us and then we're moving away from different ones like CO2. So we're comfortable in our capabilities, but on the global platform, we will have to keep expanding and have a global footprint. Part of it too is you look at logistics of shipping out of Canada into the European Union, for example, is there going to be much more user friendly to have a footprint in the EU eventually. So we're comfortable with the scale-up, but we need to continue to grow to meet global demand.

Rahul Sarugaser
Analyst, Raymond James Ltd.

Q

Okay. Great. That's [ph] helpful (52:31). Thanks so much. Appreciate it.

Jeffrey Fallows
President, Valens GroWorks Corp.

A

And I think just to add to that comment, like what we don't want to do is take a price risk, so when we have contracts and we're in negotiations, and I think Tyler mentioned that, we're seeing a ramp-up on isolate [ph] vape (52:45) demand globally. We want to make sure we have that input. And especially when you go to hydrocarbon, again I'll reiterate that you need a higher terpene profile, you need a certain [ph] cult of our strain (52:55), so we want to go out and source that today and that's what we've done over that time period.

Operator: Thank you. Our next question comes from the line of John Chu with Desjardins Capital Markets. Please proceed with your question.

John Chu
Analyst, Desjardins Capital Markets

Q

Hi. I guess one last follow-up question. So on – you mentioned that you expect the lot sizes to increase in the second half of the year. But I'm curious what's the rationale for that if most customers are still trying to get a feel what form factors and brand resonate with the consumers, the fact that [indiscernible] (53:31) enough sales data at this point to really get in that comfort level yet and also just because they don't want to be over-flooding any particular product and then risk the products being returned, so I'm just curious what's the rationale for taking the lot sizes they should increase in the back half of the year.

Jeffrey Fallows
President, Valens GroWorks Corp.

A

Sure, John. So it's really a sliding scale. So while on mass, I would agree with your comment that people are trying to figure out what products make sense. But there are successes. There are products that are doing well and there are products that are leading categories and they are in many cases products that we are manufacturing. So there's initial signs that they'll start to focus on some of these higher selling products. So that's why we feel comfortable saying we believe that those lot sizes will continue to increase over the course of the year. But at the same time, you are correct that the market is still trying to figure itself out. And so that's not an absolute statement, it's more of a sliding scale.

John Chu
Analyst, Desjardins Capital Markets

Q

Thank you. That's from me.

Operator: Thank you. Ladies and gentlemen, we have reached the end of our question-and-answer session. I'll now turn the floor back over to Tyler Robson, CEO, for closing remarks.

A. Tyler Robson
Chief Executive Officer & Director, Valens GroWorks Corp.

Thank you, operator. To close, I want to reiterate a key differentiator that separates The Valens Company from its peers, our intellectual property. The investment our company made in IP in its early stages has already and will continue to both benefit our business and our customers as Cannabis 2.0 market evolves. Our cannabis-derived terpene database has set our customers' vape pens apart from others in the marketplace and are top ranked among provincial retailers, and our SōRSE by Valens emulsion technology which aided in our ability to be the first to market in Ontario with beverages allows consumers predictable, experiences with zero cannabis taste, odor or color and a predictable onset/offset.

Our proprietary technology and advanced R&D capabilities allow us to bring high-quality, differentiated products to the market. And it is evident that our existing and prospective customers are recognizing this demand increases through fiscal 2020. We only expect this demand to continue as we bring hydrocarbon products including crumbles, waxes, shatter, live resins and other concentrates into the market starting at the beginning of Q3. The third and fourth quarters of fiscal 2020 will allow us to showcase our capability as a leading cannabinoid-based product developer and manufacturer. We are just getting started here at The Valens Company.

In closing, I would like to thank everyone on the call today for your ongoing support, allowing The Valens Company to grow as an innovator in the cannabis industry, and serve our customers safely and efficiently. We wish safety to all listeners and their families.

With that, I'll ask the operator to close the line.

Operator: Thank you. This concludes our conference today. Thank you for your participation and have a wonderful day.