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Aphria Research (11/25/19)

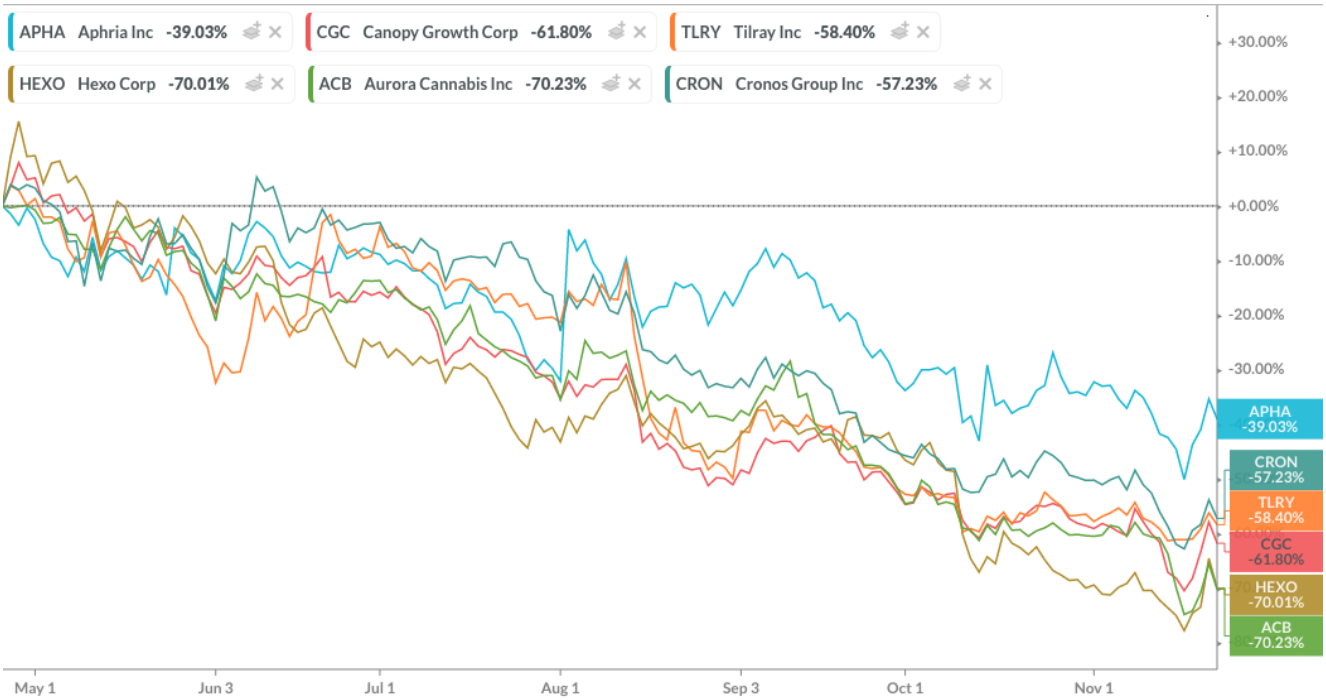
Description: Aphria Inc. produces and sells medical cannabis in Canada and internationally. The company offers pharmaceutical-grade medical cannabis and adult-use cannabis under the Solei, RIFF, Good Supply, and Broken Coast brands. It serves patients and consumers through distributors and online. The company is headquartered in Leamington, Canada.

Ticker: APHA
Price: $4.67
Market Cap: $1.18B
Performance: -17.9% YTD
Dividend Yield: N/A

Analysis

As most people know, Aphria (APHA) is one of the more popular marijuana companies on the public markets and as a result has also been the victim of a massive sell off like many of its peers since Q2 of this year.

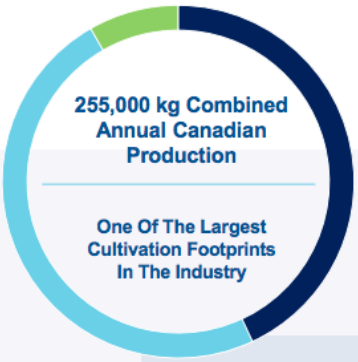
As we can see in the chart below, since late April, weed stocks have done nothing but fall with companies like Canopy Growth, Tilray, Hexo, Aurora, and Cronos all falling over 50% and as much as 70%. Aphria, while also having a rough year, has actually been doing much better than its peers by falling 39% since April and only 18% YTD.



Let's break the company down a bit and see why exactly they are outperforming their peers. Here are a few reasons many are bullish on Aphria:

1. The Company has supply agreements with all the provinces and the Yukon Territory in Canada, representing access to 99.8% of Canadians.
    a. According to OCS data, APHA has a 12% market share in Ontario
2. The Company is one of a handful of licensed producers which has agreements with every province in Canada.
3. The Company obtained approval from Health Canada in March 2019 expanding the licensed growing area at Aphria One from 300,000 sq. ft. to over 1,100,000 sq. ft. The Company also has received a second site licence for Aphria Diamond that provides an additional 1,300,000 sq. ft. of licensed greenhouse growing area.
4. The Company has international operations or strategic relationships in Australia, Argentina, Colombia, Denmark, Germany, Italy, Jamaica, Lesotho, Malta, Paraguay and maintains an option for entry into Brazil.
    a. Awarded Provisional Medical Cannabis Cultivation License by the German Federal Institute of Drugs and Medical Devices
5. Has generated back to back consecutive quarters of profitability
6. Healthy cash on hand
7. Nice diversified product line (see below)

Facility	Type of Facility	Current Size	Current Capacity[1]	Expected Capacity[1]	License Status
Aphria One	Greenhouse	1,100,000 sq. ft.[2]	110,000 kg/yr cultivation[2]	110,000 kg/yr cultivation	Fully Licensed[2]
Aphria Diamond	Greenhouse	1,300,000 sq. ft.	140,000 kg/year cultivation	140,000 kg/year cultivation	Fully Licensed
Broken Coast	Indoor	45,000 sq. ft.	5,000 kg/year cultivation	5,000 kg/year cultivation	License Expansion Under Way
Aphria Deutschland	Indoor	65,000 sq. ft.	NA	7,000 kg/yr cultivation	Awarded
Jamaica	Outdoor	150,000 sq. ft.	17,000 kg/yr cultivation	17,000 kg/yr cultivation	License Approved



Solei Sungrown Cannabis ("Solei") is designed for current and novice users, pairing an assortment of carefully curated strains and product formats for different experiences. Solei's signature 'Moments' based approach has received very positive feedback from retailers and consumers seeking a simplified approach to cannabis.

RIFF is a culture and community focused brand supporting the artistic community across Canada. The brand has high potency offerings available for more experienced users.

Good Supply offers regular cannabis users with a no-frills, yet excellent value-for-money assortment that does not sacrifice quality.

Complementing Aphria's in-house brands, the Company's wholly-owned subsidiary **Broken Coast** is a multi-award-winning craft grower that delivers a premium product and provides consumers with an opportunity to access a brand synonymous with British Columbia-grown cannabis. Broken Coast's craft cannabis is grown on the shores of the Salish Sea in small batches using single-strain growing rooms. All flower is hand-trimmed and slow-cured ensuring premium product quality and consistency.

Here are some key reasons why people are bearish on Aphria:

1. Entire marijuana market has experienced a significant drop in pricing power alongside elevated inventory levels from current oversupply
2. Canadian cannabis company Aleafia Health terminated its wholesale cannabis supply agreement with Aphria. The terms in place had Aphria providing up to 175,000 kg equivalents of cannabis products over an initial five-year term to Aleafia. At a relatively conservative price of $3/gram, Aphria could have made over $500 million from the supply deal and, if they could match Aurora's gross margins, Aphria might have generated over $300 million in gross profit from the deal.
3. Cash burn of C$100M in Q1
4. Q/Q slowdown in revenues from C$128M to C$126M
5. Shrinking cannabis gross margins
6. Growth has been more so derived from acquisitions as opposed to organically
7. Overall legal and political uncertainty for U.S. market as well as other key markets worldwide
8. Increased all-in cost per gram of cannabis

Stats & Figures

At the top, APHA posted Q1 GAAP EPS of C$0.07 beating estimates by C$0.10 on revenue of C$126.11M (+848.9% Y/Y) missing by C$6.18M.

Last quarter, they reported Q4 GAAP EPS of C$0.05 beating by C$0.15 on revenue of C$128.6M (+969.0% Y/Y) beating by C$29.34M.

With regard to cannabis products, the company brought in $35M in revenue vs. $33.5M last quarter.

Revenue from cannabis products	Three months ended August 31, 2019	May 31, 2019
Revenue from medical cannabis products	$ 10,242	$ 10,855
Revenue from adult-use cannabis products	$ 19,961	$ 18,506
Wholesale cannabis revenue	$ 4,876	$ 4,171
Revenue from cannabis products	$ 35,079	$ 33,532

Approximately 29.1%, came from medical cannabis, nearly 56% came from adult-use cannabis, and the remaining, 13.9% came from wholesale cannabis revenue.

Revenue from cannabis products	Three months ended August 31, 2019	May 31, 2019
Revenue from dried flower	$ 25,098	$ 24,886
Revenue from oil	$ 9,981	$ 8,646
Revenue from cannabis products	$ 35,079	$ 33,532

If we dive a little deeper, of their cannabis revenues, 71.5% comes from dried flower cannabis vs. 28.5% from oil.

"All-in" cost of sales of dried cannabis per gram	Three months ended August 31, 2019	May 31, 2019
Production costs	$ 15,454	$ 13,333
Less:		
Cost of accessories	$ (2)	$ (7)
Cannabis oil conversion costs	$ (426)	$ (250)
Adjusted "All-in" cost of sales of dried cannabis	$ 15,026	$ 13,076
Gram equivalents sold during the quarter	5,969,436	5,574,298
"All-in" cost of sales of dried cannabis per gram	$ 2.52	$ 2.35

A major issue many marijuana companies are dealing with right now is margins – both from pricing at the top line and costs per gram. Q/Q APHA saw their all-in cost per gram of dried cannabis jump C$0.17, or 7.2% increase.

	Q1 - 2020	Q4 - 2019
Distribution revenue	$ 95,327	$ 99,186
Net cannabis revenue	$ 30,785	$ 28,608
Kilogram equivalents sold	5,969.4	5,574.3
Kilograms produced, net	10,581.4	7,597.9
Production costs	$ 15,454	$ 13,333
Cost of goods purchased	$ 83,104	$ 87,270
Cash cost to produce dried cannabis / gram[1]	$ 1.43	$ 1.35
"All-in" cost of sales of dried cannabis / gram[1]	$ 2.52	$ 2.35
Gross profit before fair value adjustments[1]	$ 27,554	$ 28,185
Adjusted distribution margin[1]	12.8%	12.4%
Adjusted cannabis margin[1]	49.8%	53.0%
Adjusted EBITDA from cannabis operations[1]	$ 1,329	$ 1,851
Adjusted EBITDA from businesses under development[1]	$ (4,234)	$ (5,514)
Adjusted EBITDA from distribution operations[1]	$ 3,940	$ 3,872
Cash and cash equivalents & marketable securities	$ 464,319	$ 570,996
Working capital	$ 612,973	$ 642,284
Capital and intangible asset expenditures - wholly-owned subsidiaries[1]	$ 19,277	$ 26,828
Capital and intangible asset expenditures - majority-owned subsidiaries[1]	$ 20,071	$ 16,943
Strategic investments[1]	$ 34,722	$ 6,862

On a Q/Q basis:

- APHA saw a C$4M drop in distribution revenue and $2M increase in cannabis revenue.
- A slight uptick in distribution margin of 40bps to 12.8%
- A steep drop in cannabis margins of 320 bps to 49.8%
- Kg sold increased by 7%

On a Y/Y basis, as seen below:

- Revenue increased by about 850%
- Gross profit increase 230% (far less than revenue growth)
- Adjusted gross profit growth of 81%
- Adjusted cannabis gross margins fall from 63.6% to 49.8%
- Adjusted EBITDA of C$1.03M vs. a loss of about C$4M
- Cost per gram increased from C$1.83 to C$2.52
- The company's average selling price to the adult-use market in Q1 2019 per gram including excise tax was $7.51 per gram vs. 6.02 this quarter – a drop of 24.8% Y/Y

	Three months ended	Three months ended
	August 31, 2019	August 31, 2018
Net revenue	$126,112	$13,292
Gross profit	$45,421	$13,764
Adjusted cannabis gross profit [1]	$15,331	$8,458
Adjusted cannabis gross margin [1]	49.8%	63.6%
Adjusted distribution gross profit [1]	$12,223	N/A
Adjusted distribution gross margin [1]	12.8%	N/A
Net income	$16,441	$21,176
Adjusted EBITDA [1]	$1,035	($3,964)

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	Q1 - 2019	Q4 - 2018
Revenue	$ 13,292	$ 12,026
Kilograms equivalents sold	1,778.2	1,312.6
Production costs	$ 4,441	$ 2,245
Cash cost to produce dried cannabis / gram[1]	$ 1.30	$ 0.95
"All-in" cost of sales of dried cannabis / gram[1]	$ 1.83	$ 1.60
Adjusted gross margin[1]	63.6%	78.7%
Adjusted EBITDA from ACMPR operations[1]	$ (828)	$ 2,227
Cash and cash equivalents & marketable securities	$ 313,982	$ 104,799
Working capital	$ 363,245	$ 150,758
Capital and intangible asset expenditures - wholly owned subsidiaries[1]	$ 28,036	$ 39,042
Capital and intangible asset expenditures - majority owned subsidiaries[1]	$ 29,727	$ 24,052
Strategic investments[1]	$ 29,368	$ 5,946

	Three months ended August 31, 2019	Three months ended May 31, 2019	Three months ended August 31, 2018
Net Revenue	**$126,112**	**$128,567**	**$13,292**
Gross Profit	**$45,421**	**$36,007**	**$13,764**
Fair Value Adjustment on Sale of Inventory(1)	**$7,286**	**$9,649**	**$4,205**
Fair Value Adjustment on Biological Assets(2)	**($25,153)**	**($17,471)**	**($9,511)**
Adjusted Gross Profit	**$27,554**	**$28,185**	**$8,458**
Adjusted Gross Margin	**21.8%**	**21.9%**	**63.6%**

	Three months ended August 31, 2019	Three months ended May 31, 2019	Three months ended August 31, 2018
Revenue from Cannabis Produced	**$35,079**	**$33,532**	**$13,292**
Excise Taxes	**($4,294)**	**($4,924)**	**NA**
Cannabis Net Revenue	**$30,785**	**$28,608**	**$13,292**
Productions Costs	**$15,454**	**($13,443)**	**$4,834**
Adjusted Gross Profit from Cannabis Operations	**$15,331**	**$15,165**	**$8,458**
Adjusted Gross Margin from Cannabis Operations	**49.8%**	**53.0%**	**63.6%**

Aphria gave their FY2020 guidance last quarter and did not change it after reporting their Q1 2020 report. The guidance remains:

- Net revenue of approximately $650 million to $700 million, with distribution revenue representing slightly more than half of the total net revenue
- Adjusted EBITDA of approximately $88 million to $95 million

This is where CUBE gets a little worried. Essentially APHA has 3 quarters to go to achieve an additional C$522M in revenue and C$87M in EBITDA to hit the lower end of their guidance. If APHA were to deliver zero growth, similar to Q4 to Q1 which actually saw negative growth, for the remaining 3 quarters, they would only post revenue of C$504M, well below C$650M, and EBITDA of C$4M, way below $88M.

So where does APHA see this huge jump in margins coming from? APHA believes growth in cannabis with the addition of edibles and vapes will propel the company to hit these targets but CUBE isn't as optimistic. This kind of surge in the business would be insane and based on the way shares are priced right now, Wall Street doesn't think so either.

If we look at the conference call transcript, we see the following:

"

Owen Bennett (Jefferies Analyst)

And -- yeah, just a couple of questions from me, first of all, on the guidance, so capacity and looks like and coming online as expected and with Health Canada expediting Diamond now. I was just wondering, what sort of industry growth do you need to see or are you planning on those assumptions to hit that $650 million, $700 million? And then, maybe if you could give a bit of color in terms of how you see the mix between flower and new derivative products in that $650 million to $700 million. And then my follow-up is just any more color around the U.S., you briefly mentioned partnerships and alliances for growth kind of is -- we expected to hear something around the U.S. any time soon? Thank you.

Irwin Simon

Okay. That's all like the multi-part question. So let's deal with good steps. In terms of the split between dried flower and the new derivative products we have been on record multiple times. We think that dried flower remains a predominant share of the market going forward.

But that the vapes category and the new derivative products start to take significant amount of market share fairly quickly. Our internal models are really based around 60% market share for dried cannabis, 20% to 30% for vapes and the remainder being split between drinks, edibles and the other new product formats.

In terms of growth within the industry itself in our ability to meet our guidance and we see a couple of different things. One, we see our ability over the last few quarters to see significant amounts of share in this space driven by the strength of our brands.

We are consistently hearing from the individual store owners more and more people come in and asking for our individual brands and the sales capabilities we have today are really be -- were really driven by the amount of supply we have and when supply freeze up we see being able to steal more space on the shelf and be able to steal more share.

We do have some growth forecasted in our number for new store openings. We recently saw that Quebec has made an announcement. We see Ontario has got some new stores coming on, obviously, the -- those new stores and their ultimate opening will impact that. But as of today the information we have we believe those will help drive that number as well.

And Owen, just on that, our brands have only been around less than a year and the awareness team is built, and this is an industry that's tough to build brands, because you are not allowed to advertise the brands, so it's getting the consumers to try and repeat sales.

So I come back and say, just think of our brands are around for five years consumers then start to know our brands, know the quality of our brands and why it's much better to be buying our brands at retail outlets then be buying products in the illicit market and that's the biggest opportunity.

The 25% of sales only comes today from recreational products that are sold in stores. The big opportunity for us is how we continuously take away sales from the illicit market. So, and as Carl said, Canada expects to have over 3,000 stores within the next three years to five years with a 1,000 year in Ontario.

So just by additional store expansion, additional products and us with our brands out there creating brand awareness and educating the consumer, the value of buying the brand in the stores so the illicit market will drive our sales.

Also there is a big focus here on medical with the niche joining us and taking over our medical business. We think there is a lot of patients that we can add to our medical database there. So the opportunity is there tremendously.

"

All in all, the APHA is assuming they can capitalize on 60% market share in dried cannabis and 20-30% in vapes, edibles, drinks, etc. This is implies some massive wins for the company and it is something CUBE isn't confident will happen. We have seen time and time again where cannabis companies issue guidance that simply can't be met like that of HEXO, CannTrust and others.

Another reason APHA believes they can hit this target is not only from increase production, but also from a major drop in the cost per gram due to their newly licensed Aphria Diamond facility.

The CFO said on the call, "We are sitting at a cash cost of $1.35 in the quarter and, sorry, $1.43 in the quarter and we are expecting below $1 as we ramp into Diamond and get that fully operational. The scale that we get from our facilities drives out a number of costs at Aphria One. We are still in the process of ramping up that facility. Its capacity was at 55,000, sorry, it's ramp was at 55,000 at the end of the quarter."

The issue here is that more production doesn't mean more sales. Right now to CUBE, the Canadian market doesn't look like its in need of more supply hence why the price APHA can get per gram has fallen by 25% Y/Y.

At this valuation of $1.2B, APHA doesn't look too expensive but personally we can't pull the trigger on APHA just yet as we are nervous that in the next quarter we could see that guidance get revised to the downside especially given this part of the conference call:

John Zamparo

Okay. Understood. Thanks. And my follow-ups on the Aleafia contract, I know you said in your press release this is a material. Just to clarify though, is none of the original EBITDA guidance including contributions from that contract or is it that you assume you will find new buyers and assuming it's the latter, what is that you assume on wholesale versus retail for that product?

Irwin Simon

So, number one, the Aleafia contract was a legacy agreement. It was built into our absolutely guidance. And we expect to replace that with retail customers and other products to do support those sales that we wouldn't have got from Aleafia and at better prices and better opportunities out there within both flower and oil prices.

This is very concerning because it looks to me like instead of revising the guidance downwards on this material impact, APHA is believing they can move that product elsewhere to make up for it. This was a big deal with Aleafia and as we previously mentioned the terms in place had Aphria providing up to 175,000 kg equivalents of cannabis products over an initial five-year term to them. At a relatively conservative price of C$3/gram, Aphria could have made over C$500M from the supply deal.

Point blank, CUBE sees APHA missing this guidance which is enough for us to keep away from the stock until they make it known to the Street and show all of their cards – until then there is simply too much risk of seeing that PR come out that they are missing guidance to send shares spiraling by over 20% like many others we have already seen.

Technical Analysis

Many cannabis companies have seen a recent pop last week and we believe it is short-lived. APHA in particular was denied by its 50DMA of $5.14 and pulled back quite a bit already and the downtrend still remains intact for the industry. In the near-term we see shares visiting their S1 support line of $4.25 as the stock was unable to hold its crucial pivot point of $4.98 after getting rejected by the 50DMA. In the event, APHA does break its 50DMA it will meet another resistance level at $5.72. On the opposite end, if APHA does not hold its S1 support line of $4.25, it will most likely visit the bottom Bollinger band of $4.05. As mentioned already, we are going to avoid APHA for the time being as the charts and more so fundamentals with regards to its sky-high guidance make it very risky.