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VFF.TO - Q2 2018 Village Farms International Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to Village Farms International's Second Quarter 2018 Financial Results Conference Call. Yesterday, Village Farms issued a news release reporting its financial results for the second quarter ended June 30, 2018. That news release, along with the company's financial statements, are available on SEDAR and on the company's website at villagefarms.com, under the investors heading.

Please note, that today's call is being broadcast live over the Internet and will be archived for replay both by telephone and via the Internet beginning approximately 1 hour following completion of the call. Details of how to access the replays are available in yesterday's news release.

Before we begin, let me remind you that forward-looking statements may be made today, during or after the formal part of this conference call. Certain material assumptions were applied in providing these statements, many of which are beyond our control. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed or implied in forward-looking statements.

A summary of these underlying assumptions, risks and uncertainties is contained in our various securities filings, including Village Farms' current annual information form for the year ended December 31, 2017, and MD&A for the quarter ended June 30, 2018. These forward-looking statements are made as of today's date, and except as required by applicable securities law, we undertake no obligation to publicly update or revise any such statements.

I would now like to turn the call over to Michael DeGiglio, Chief Executive Officer of Village Farms International. Please go ahead, Mr. DeGiglio.

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

Thank you, Stephanie. Thanks, everyone, for joining us both by telephone and Internet. With me today for the call is Village Farms' Chief Executive Officer (sic) [Chief Financial Officer], Stephen Ruffini. In terms of the agenda for today's call, I'll begin with an update on the continuing process at Pure Sunfarms, our joint venture for large-scale, high-quality, low-cost cannabis production in Canada. Steve will then do a brief review of our second quarter financial results, and I'll return for some concluding comments before Steve and I take your questions.

So beginning with Pure Sunfarms. It's been a very busy and productive summer so far, as our cannabis joint venture achieved several important milestones on or ahead of our planned schedule. As I discussed in our last call in May, Pure Sunfarms received its first amendment to the cultivation license for the 1.1 million square foot, Delta 3 facility in Delta, British Columbia, which enabled the Pure Sunfarms' team to begin commercial scale production on the first 130,000 square feet. Just a month and half later, Pure Sunfarms received its second amendment, enabling to expand production at Delta 3 -- at the Delta 3 facility to 225,000 square feet. By the end of July, all of the flower rooms and the license area were fully planted out and in production. On July 27, Pure Sunfarms received its sales license from Health Canada for the Delta 3 facility. We are incredibly proud of the speed, at which Pure Sunfarms is able to achieve this, especially given the magnitude of the operation with ongoing construction and management employee ramp-up, just 144 days from receipt of the cultivation license, to our understanding about twice as fast as the average. It's a testament to the value of the decades of operational experience that Village Farms brings to the table, combined with our unwavering approach to always do things the right way and the right way the first time.

Pure Sunfarms has since completed its first sales of cannabis. So in well under a year since submitting its application for a cultivation license, Pure Sunfarms has completed conversion of 500,000 square feet, or half of the facility with the first 250,000 square feet of Delta 3 growing and harvesting at commercial scale, and now generating its first revenues, and as we wait approval for the next expansion. As you will recall, Pure Sunfarms had an initial distribution agreement in place and is in discussions with other licensed producers for supply, there's no shortage of interest, and we're also discussing opportunities with various provincial government distributors.

Looking out a little further, we know that reliable suppliers of high-quality, consistent of large-scale, will be valued in the marketplace, and we believe, we are well positioned for whatever the retail market holds going forward, is consistent change, and we are standing by to see where it ends up, but Pure Sunfarms has become a vertically integrated producer, as we have said, with its own products and its own brands, and we are confident that Pure Sunfarms' goal to be the lowest-cost producer in Canada will provide it with an increasingly meaningful competitive advantage a very durable, sustainable company in the long term, as the cannabis market finds its niche and matures. I am also pleased to report that we have continued to -- we are in the final stages of the conclusion for the presidency of Pure Sunfarms, and with the sales license in place, Pure Sunfarms will aggressively move on its product development and branding strategies, including on -- as I have said, importantly, even at this early stage in our production, Delta 3 facility is operating exactly as intended.

The team has now completed multiple harvests, and both the quality of our product and yields are exceeding our expectations. Every day, we're benefiting from the deep experience of the growing team, the existing skilled labor force, and specific knowledge and advantages that come with 2 decades of operating a very large-scale greenhouse, including years of understanding the microclimate that's unique to the Delta facility, provides us with a tremendous advantage, and significantly derisks our production ramp-up.

That said, I am not surprised growing any crop of this kind on a massive scale, is a complex and challenging undertaking. That's what Village Farms has been doing successfully for 30 years.

We're also extremely satisfied with the performance of the nursery, and its ability to keep pace with our expansion. In fact, we now know the nursery not only has the capability to supply our Delta 3 facilities, but also other facilities and other producers as well. Conversion of the remaining 1.1 million square feet continues to progress right on track and we can -- and we continue to expect the entire 1.1 million square feet to be converted by year-end, with the majority of that approximately 75% in production through the winter, and full production beginning in the second quarter of next year. As a reminder, from October to March, as per our plan, production will be temporarily suspended in quadrant 1 at Delta 3. The quadrant we are currently growing in, as we go back and install the light fixtures. Quadrants 2, 3 and 4, 750,000 square feet are all being converted with lighting right from the start.

The rented generating equipment to power supplemental lights through this coming winter is on track, to be operational by 1 October. As a reminder, for the next winter, we have secured 24 megawatts of permanent power from the local utility, which will be operational for Delta 3 by December of 2019.

Village Farms has also secured another 24 megawatts of power should we decide to use it in 2019.

Before I turn the call over to Steve, let me touch briefly on our incumbent produce business. Revenues of \$42 million, was down about 8% year-over-year, mostly due to low volumes. In Canada, we have not fully replaced the capacity from the transfer of the 25 acres of Delta 3 facility to Pure Sunfarms.

In the U.S., volumes were impacted by a planned maintenance at our Monahans facility, we took it out of production, to do a full cleanup for the first time since 2012, so we will be out of production or we were for about a quarter. Record temperatures in Texas and some weather-related damage affected one of our facilities and some of our production. So with that said, profitability this year continues to be impacted by significant higher freight costs, which were up actually 10% year-over-year, freight being in our cost of sales, as the entire U.S. economy struggles with limited trucking capacity in the wake of new regulations. In addition, we're still monitoring potential changes to NAFTA, where negotiations continue, and investing in more local housing in Texas to offset increased labor costs and availability. Our produce business continues to focus on maximizing margins through exclusive margin rise and low-cost production, as we provide the highest quality and safest produce to leading grocers across the U.S. and Canada, which we have done for 30 years, as I've said, many times, really strong, years of experience driving our cost in our greenhouse



operations will be of tremendous value to Pure Sunfarms going forward. I now would like to turn the call over to Steve to walk through our financial results in detail. Steve?

Stephen C. Ruffini - *Village Farms International, Inc. - CFO, Executive VP, Company Secretary & Director*

Thanks, Mike. Our complete second quarter and year-to-date 2018 financial results and discussion are available on SEDAR, albeit, they were not posted till this morning due to SEDAR system wide issues that all filers experienced yesterday. I'm happy to go into more detail in the Q&A at the end of the call. I will remind you that most of the numbers I will discuss are in U.S. dollars and when I discuss Pure Sunfarms I will discuss Canadian dollars.

Sales for the second quarter of 2017, as Mike said, \$42 million, down 8% primarily, the decline is primarily due to lower volumes, Mike has already discussed. Overall cost of sales for Q2 decreased 3%, to \$41.2 million, \$42.8 million primarily, due to the decrease in volumes as well as the decrease in third-party contract sales costs, which was offset by, as Mike said, increased freight expense and increased labor costs at both our Texas and BC facilities.

Selling and other general and administrative expenses for Q2 increased 5% to \$3.4 million from \$3.2 million, primarily related to higher public company related activities, such as Investor Relations, legal and listing fees, in the second quarter of 2018 versus '17.

We reported a net loss of second quarter of 2018 of \$2.3 million or a loss of \$0.05 per share compared to a net profit of \$4.3 million or \$0.11 per share in Q2 of last year. Last year was primarily, profitability was primarily driven by an \$8.6 million book gain recognized on the contribution of the Delta 3 facility, to Pure Sunfarms in June of 2017. Our EBITDA for Q2 was a negative \$1.3 million compared to a positive \$1.3 million in the same period last year.

Since our full finances were not posted until this morning, in all likelihood, no one has had time to read them and in fact, if anybody actually ever does read them. But I would like to go into the Pure Sunfarms financials, which are contained in the footnote, the Village Farms' full financials. As most of the people on the call are probably more interested in the Pure Sunfarms business than our fresh produce business. So I want to highlight a few financial items with respect to Pure Sunfarms. We continue to have low overheads as our primary focus has been converting facility, giving our Health Canada licenses, and building the back office to support our oncoming sales activities. For the quarter, we incurred CAD 761,000 of operating expenses, having incurred CAD 1.3 million year-to-date of operating expenses. For most of the long-term investors of those farms you've heard me talk about our bio asset accounting, which is required by the IFRS. The cannabis businesses, is no different. So for the first time, on June 30, Pure Sunfarms is reporting and has recorded a bio asset. The bio asset, as indicated in footnote 7 of the Village Farms' financial statement, has bio asset value of CAD 420,000 as of June 30. This figure essentially represents the gross margins at sales value less cost of production and ancillary selling costs of the buds on the plants as of the reporting date on June 30, which was very limited and essentially was one flower room on the reporting date of June 30.

Pure Sunfarms did not value, as others do and are allowed to do, the full value of the plants in the facilities. So we -- the plants in the nursery, for instance, are carried at cost and are not contained in the biological value.

So Pure Sunfarms has valued just the buds-on-the vine which for the most part, have either been sold or being in the process of prepared for sale. So while a very small sample of what's forthcoming, the initial production is profitable, and we expect to report positive net income from Pure Sunfarms beginning in Q3, and Pure Sunfarms will be generating positive cash flow from operations in Q4, and generating excess cash flow starting in Q1 of 2019.

That concludes my remarks, and I'll turn the mic back over to Mike.

Michael A. DeGiglio - Village Farms International, Inc. - Founder, CEO, President & Director

Thanks, Steve. We are now through 62 days from federal legalization of adult-use cannabis in Canada Village Farms through our 50% of ownership of what will soon to be one of the largest cannabis production operations in Canada and perhaps is well on the verge of transforming its earnings trajectory in the process. And many ways we have taken a differential path to get where we are today.

We entered the industry later than many of the other large LPs. We entered the industry underpinned by \$200 million a year produce business. We've been very capital efficient, converting existing greenhouse facility operations and pursuing a partnership model. As a result, we've had limited shareholder dilution, I'm proud to be able to say that Village Farms has been able to achieve everything it has, in terms of Pure Sunfarms without hiring a single additional person within the organization. All of this, we believe, will contribute significantly to shareholder value, as we expand production and drive revenue and cash flows in Pure Sunfarms. Pure Sunfarms has had to prove itself every step of the way, conversion, licensing, production and sales, all within less than a year. As we continue to do so, we will continue to ramp production up, as we ramp-up sales and as we begin to generate positive cash flow, which we expect to do shortly. I'm confident that Pure Sunfarms and Village Farms (inaudible) both begin to recognize for the significant long-term value, what is being generated. With that, I'd like to open up the call to any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Russell Stanley with Echelon Wealth Partners.

Russell Stanley - Echelon Wealth Partners Inc., Research Division - Equity Analyst of Special Situations

I guess my first question, with respect to quality and yield. Can you talk about, I guess, what your current yields are? And how that reflects or inputs your -- informs your production estimates for this year and next?

Michael A. DeGiglio - Village Farms International, Inc. - Founder, CEO, President & Director

Well, I think, the second part of question, I'll answer the second part, I mean, we feel very confident about the production yields we have put out for both this year and next year.

So what we're seeing makes us feel extremely confident, but we're in the midst of conversion and it's very hard to put out yields based on 1 harvest. As you remember, we're doing 85, once we ramp-up, it'll be 85 harvest a year and 17 grow rooms roughly 5 to 5.5 per room. So we really need to get a lot more traction before we can look at where the yields will start leveling off at that point. But I can say that we are confident in exceeding our expectations that we put out.

Russell Stanley - Echelon Wealth Partners Inc., Research Division - Equity Analyst of Special Situations

Excellent. And with respect to quality, I guess, can you comment or provide some color as to how you're measuring that against what you were expecting?

Michael A. DeGiglio - Village Farms International, Inc. - Founder, CEO, President & Director

Well, it's still early in the game, but I mean out -- what we have -- we have had 100% harvest of meeting out specifications and what we anticipate the specifications in the market. Though basically, we are harvesting everything we're growing, and it's meeting the spec, we have had, even to our, sort of surprise, we've had no shrink whatsoever, and that quality spec is being met. So -- and if we judge it from what we're hearing from the customers we are selling, there is no issues at this point in time. And keep in mind that we have to go through a whole year cycle, because they're

growing in the summer or during the summer is much different than growing in the fall and winter. So we really need to get some more traction again, where we can say that with confidence on a full year cycle. We also are -- we are increasing our strains that we're growing, to have a good choice on where we want to focus, and what strains we want to focus on, both THC strains and CBD strains, but we definitely need more time to get through that rustle.

Russell Stanley - *Echelon Wealth Partners Inc., Research Division - Equity Analyst of Special Situations*

Okay, that's helpful. And just, I guess, switching gears to the sale side. I am not sure what detail you can provide, but any color on who you are selling to at this point?

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

At this point, we are selling to other LPs. Obviously, Emerald is included on that list. We've announced that supply agreement. We are selling to other LPs, by word and as spot basis, as the product is available. People are essentially bidding for it. With respect to, everyone has seen, BC has announced a new RP proposal. So Pure Sunfarms now has the sales license, will potentially be putting in products in -- by the end of the month as requested by the BC Liquor Board. So we are looking forward to selling products to them based on; however, the roll out goes in BC.

Russell Stanley - *Echelon Wealth Partners Inc., Research Division - Equity Analyst of Special Situations*

Great. And I guess, it dovetails with my last question, you mentioned BC, I guess, can you talk a little bit about beyond that where your geographic sales priorities are at this point, as far as the provinces are concerned. I am assuming Ontario is there, but can you, I guess, elaborate on where else you might be looking?

Stephen C. Ruffini - *Village Farms International, Inc. - CFO, Executive VP, Company Secretary & Director*

Yes, we're ramping up and as Mike mentioned, the executive for Pure Sunfarms is getting close, and he and his sales and product development team will be making those decisions, as we go forward.

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

Right. And keep in mind, we still have as we've projected for 2018 about 7,000, 8,000 kilograms that we don't start to ramp-up really till we get into 2019. So we certainly don't want to be out there, overcommitting till we have the quality of the product. So working in BC where we are located makes the most sense at this point in time.

Operator

(Operator Instructions) Your next question comes from Bruce Schindler with Stockbridge Associates.

Bruce L Schindler

Want to congratulate you on the great progress and this incredible timing on the sales license that came so fast. I'm an investor in other companies and I know they're waiting 8 to 12, and in some cases over a year for that sales license. I would also like to congratulate you on increasing with Great Northern the value of that working relationship. In particular, I'd like to in the Echelon report that I'm sure you read that came out, I believe, on Monday, it talks about this 40% that Emerald has committed to. I'd like to know, is this cast in stone and in writing and part of your JV, that Emerald gets off the top 40% of production of the smaller amount in '18 and of the larger amount in '19. Is that cast in stone?



Stephen C. Ruffini - *Village Farms International, Inc. - CFO, Executive VP, Company Secretary & Director*

It -- Bruce, this is Steve. It's not in the shareholder agreement. It's a separate supply agreement that we entered into on behalf of Pure Sunfarms for the periods 2018 and '19, but it's not a requirement of shareholder agreement. It was a separate arms-length transaction, between essentially two LPs, Pure Sunfarms and Emerald.

Bruce L Schindler

Okay. And next, I'd like to ask about the next 25 acres potential. I am sure, you have enough on your plate obviously, in expanding all the footage in Delta 3, I guess, is what it is, but can you give any insight into the 25 acres and how those conversations might be coming along?

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

I can. Well, first of all, the Village Farms gave Pure Sunfarms an option for the existing -- other existing facilities Delta 1 and 2, 1 being -- Delta 2 being 25 acres or another 1.1 million square feet and Delta 1 being 60 acres or almost 3 million square feet. Those options cannot be triggered under the shareholder agreement, till such time that Delta 3 has its full cultivation license for the full 1.1 million square feet whereas, we've said, we're looking at year-end for that to occur, but Village Farms view is that we have opened those discussions up, because we can provide a waiver to Pure Sunfarms, should they want to move on that option sooner. And all I can say is we have put that forward and there's been no decision as of yet.

Bruce L Schindler

Okay. It just seems to me that -- we believe, Emerald is having any financial problems or anything it was clear in research that nothing is going to happen in the Richmond facility, they have been turned down twice. One of our group at Stockbridge can figure out what they did in Quebec and....

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

Well, I can say that, Bruce, that has nothing to do with Pure Sunfarms and nothing to do with Village Farms. So I really don't know what -- you would have to refer to Emerald, because we have no knowledge or information of that and I would rather not discuss, it's their business. So I know that I can say that Pure Sunfarms is -- looking down the road, it's not restricted to operate in any other country as an entity. And it is also looking at opportunities within Canada as well to what we're doing in Delta, or may do in Delta. So that's what I'll really say about that at this point.

Bruce L Schindler

Okay, that's very enlightening. I have some questions. Some of the figures I have seen, is when this 1.1 million feet is built out based upon projections only, that would equal about 5% of the grow in Canada and that is done by a fellow at Pacific, I forget the exact name of the research chaps. Do you concur with that? If you had seen that report about, I think, it was out about 3 months ago.

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

Yes, I've seen that report, but I guess, really, it really depends where the market is going to be in 2 years. So -- but, I would say within 5% is probably a good number based on what we think our ramp-up will be in 2020.



Operator

There are no further questions at this time.

Michael A. DeGiglio - *Village Farms International, Inc. - Founder, CEO, President & Director*

Okay. I want to thank everybody for joining this conference call and we look forward to reporting on our progress over the next couple of months going forward. Thank you.

Operator

Thank you. This concludes today's conference call. You may now disconnect.

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