THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

CGC.TO - Q3 2019 Canopy Growth Corp Earnings Call

EVENT DATE/TIME: FEBRUARY 15, 2019 / 1:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Bruce A. Linton *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Timothy Rob Saunders *Canopy Growth Corporation - Executive VP & CFO*

CONFERENCE CALL PARTICIPANTS

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

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

Martin Landry *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Michael Joseph Hickey *The Benchmark Company, LLC, Research Division - Research Analyst*

Michael Scott Lavery *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Oliver S. Rowe *Scotiabank Global Banking and Markets, Research Division - Associate*

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

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

PRESENTATION

Operator

Good morning, and welcome to Canopy Growth Third Quarter Fiscal 2019 Financial Results Conference Call. Canopy Growth issued, after financial markets closed on February 14, 2019, a news release announcing its financial results for the third quarter ended December 31, 2018. This news release is available on Canopy Growth's website and will be filed on SEDAR.

On the call this morning, we have Bruce Linton, Canopy Growth's Founder, Chairman and co-Chief Executive Officer; and Tim Saunders, Canopy Growth's Chief Financial Officer. (Operator Instructions) Certain matters discussed in today's conference call or answers that may be given to questions could constitute forward-looking statements. Actual results could differ materially from those anticipated. Risk factors that could affect results are detailed in the company's annual information form and other public filings that are made available on SEDAR. During this conference call, Canopy Growth will refer to supplemental non-GAAP measures, adjusted EBITDA. These measures do not have any standardized meaning prescribed by IFRS. Adjusted EBITDA is defined in the press release issued yesterday as well as in this period's management's discussion and analysis document that will be filed on SEDAR. Please note that all financial information is provided in Canadian dollars unless otherwise specified. Following the prepared remarks by Mr. Linton and Mr. Saunders, the company will conduct a question-and-answer session, during which questions will be taken from analysts. (Operator Instructions)

I would now like to turn the meeting over to Bruce Linton. Mr. Linton, Please go ahead.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Great. Thank you. And I welcome all. I truly enjoy our quarter end. And that's in part because I'm not in the finance department, but it's mainly because in our world, the sector we're in and the company that we've created, taking time to reflect on what actually has occurred in a prior period, only occurs when we do the preparation for this call, because we're kind of busy thinking about the next 7 quarters.

So when I think about this last quarter, it's almost possible to forget that the first sale happened and that the company with the first sale or the first legally sold gram of Cannabis was us. Or 2, almost look over the fact that we went live at the beginning of the quarter on our next-generation ERP system, which maps out the next several quarters and how that becomes a global platform, and how are we -- have done a number of acquisitions and then maybe that all the meaningful investments we've made in this quarter and I think in the next 6, 7, 8 quarters, keep showing really good yield on those investments. It's almost easy to forget that in October, we moved more units, more containers, about more -- maybe give or take a couple than we did in the history of the company up till that point in time. And so all the activities were on automation and creating that, and that we had cannabis coast to coast. And that we did a number of acquisitions that really -- the reason we do these things is we look at and work with companies and keep an eye on them and get involved with them for years and then understand them. And when we make an acquisition, whether it's Storz & Bickel or ebbu, these things have a long-time horizon. They add to our intellectual property. So when I think about having 32 issued patents and over 140 patent applications, it's because of the combinations of investments and acquisitions. And so Tim is going to do a great job of walking through the puts and takes of the quarter. But I'd like to everybody on the call to also think of kind of how we do, which -- we use a 5 to 7 quarter horizon. And that what we're doing, and where we're going and the investments we're making are on things like science, having an actual focus group called applied science. And developing intellectual property, running clinical trials to create what will be phenomenal products for both rec and medical that will have the ability to be branded globally, but they start with science, outcomes and IP.

And so when you picture this building that we began in, we have another 240,000 square feet, over 2 floors, which is that Phase I of it waiting for licensing, targeting to be in March, we'll see when it is that is all about GMP manufacturing processes, so that the science can turn into products, the products can turn into brands, and consumers can buy outcomes that are consistent and the same all the time. But that platform is multiple years. In the creation, and we'll have multiple years of benefit, the rules and regs, which we're now 5 days away from the inputs closing, February 20, the government will then say, we've had all the input we wanted, outcomes the next generation of recreational products. It has a contemplated category called beverages. We have a building that's a little bit more than 150,000 square feet, which is being put up, right now, through the winter. The decision to that building was made before there was actually the regs, but in contemplation what was likely. And that building is expected to be complete May 1, which means that we can then begin to put all of the equipment inside, so that we can then begin to make the beverages, which will use the science that we've been creating for 4 years to go into brand extensions of Tweed and a bunch that are behind the curtain that I think people on the call will like and the customers and consumers will love. And they become the first of a kind, and they become something that's they reference file for the world. And then the 16 countries we're in, whenever they choose to have anything additional to medical that's utterly permissible, we have the product set. Seek and see where that goes.

In the next 4 quarters in Canada, we're seeing, I think, a really well now stabilized platform -- program, where the provinces have had a chance to get information and get organized even more and accelerate. And so we're seeing stores open on a model that we think makes a ton of sense in many of the provinces, which goes from us on wholesale to a box controlled by the government or a virtual warehouse out to private sector retail. And that has been what we thought would work because people want to go to stores. They want to have discussions and conversations. They want to do transactions in a place that they feel is part of the experience. Our sales in this last quarter, the first quarter rack proved our model out that, that works, and that what we're seeing is that turning up from Alberta, getting faster to Ontario now nailing it. And the rest of the provinces turning them up. We're operating stores in several provinces to include retail, face-to-face as well as in some circumstances, e-commerce. And so the dataset we're getting, and the platform we're building and the experience we're having is all looping back, so that by the time we get to Q4, this calendar year, you're going to have a lot more stores and a lot more products and a lot more people who want to go to them.

I expect by that quarter, we're having clinical trials in Phase IIb that if we're correct starts to allow us to make claims on medical products. So Spectrum is this global products brand, which starts to have a specific and unique outcomes, which starts to make claims.

And that whole platform is now well understood in being educated in multiple languages. We are in a situation where I would say that the opportunity to export to certain European countries this probably what you could almost call a backlog, that's formed a little bit because of the demand growing in those jurisdictions and the need to have GMP production assets so that we meet the standard. So those investments are turning up in that way.

As we walk through this, one of the things that I was thinking about this morning is, we probably could ensure to highlight the cash per share. So when you're actually buying our stock, there's quite embedded value called cash. And that cash is aimed at all of the things I have touched on accelerating through 140 patent applications, so that we get enough data to move it, making sure that with assets that we've acquired like Storz & Bickel, we should probably be contemplating in expanding it, because this is an automated internationally certified ISO 1345 factory that with the things we are putting together is going to have -- we expect more demands through the channel. And they are already in 50 markets. So you can -- as you'd make those investments, you can look over time horizon and contemplate that there is at least a company in this emerging sector that's investment-grade long-term thinking, and we hope and expect continues to attract more and more institutional shareholders, so that we can actually continue to see the migration up into those hands [while only]. And on that basis, I'm very happy with what we've seen over the last year in terms of the names, quality and total volume of institutional purchases we've attracted.

I'm going to hand over to Tim shortly, but there was a note in there about the fact that Tim, as we looked at for our next 3 to 5 years, because everything in our word I need 3- to 5-year commits that what the right thing was for Tim and for the company was to take that view and begin looking at an org chart that adds more senior and confident finance team members, because we have a really amazing, but not really huge, not really actually sufficiently large finance team. And so we're -- you're going to see investments in that area, so that we cannot only do a great job in Canada, prepare ourselves for the U.S. hemp and other businesses and global, but also we have a function called treasury now because we have capital. So Tim was thoughtful in where he was in life and career. But he's also clear that his objective is to be continuing in assisting and accelerating what we do with the board by Tim helping to prepare that, and what we do on our ongoing M&A, because he is a very trusted and competent resource.

So we may not hear him on the phone by the time we get to Q3 or 4. But he is in the building, and that I do greatly appreciate how Tim has conducted himself, and how we've worked through this.

And I would like to hand it over to Tim to walk through the details. Tim?

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

Thank you, Bruce, and good morning, everybody. I'll now proceed with the review of the third quarter ended December 31, 2018. Gross revenue for the third quarter, including $14.7 million of excise taxes was $97.7 million. Net revenue for the third quarter ended December 31 was $83 million. Net revenues in the quarter represented 282% increase over the quarter ended December 31, 2017.

Recreation accounted for approximately $59 million or 71% of the total net revenue. Medical was approximately $16.5 million or 20%, and the remainder related to devices, merchandise and clinic revenues of $7.5 million.

The company also reported net income of $74.9 million or $0.22 per basic share as compared to $11 million or $0.01 per basic share and fully diluted share a year ago. The Q3 fiscal 2019 fully diluted EPS was a net loss per share of $0.38, and as due to the dilutive impact assuming the convertible debt was converted at the beginning of the quarter. I'll comment on earnings in a few minutes. The adjusted EBITDA loss, however, was $75.1 million as compared to $57.7 million in Q2, and a $5.7 million loss in the same quarter last year. I'll also comment on adjusted EBITDA shortly.

In the 3 months ended December 31, 2018, and 2017, oils including Softgel capsule accounted for 33% and 23% of the product revenue, respectively. In the third quarter, approximately 30% of recreational and 42% of medical sales were comprised of oils, including Softgel capsules. The total quantity of cannabis sold during the 3 months ended December 31 was 10,102 kilograms and kilogram equivalents, up from 2,330 kilograms and kilogram equivalents in the same period last year. Cannabis shipped on a wholesale basis to a provincial and territorial partners which is called B2B, accounted for 7,831 kilograms.

Sales through our own retail channels -- stores in Newfoundland and Manitoba under the Tweed and Tokyo Smoke brands and through e-commerce totaled 906 kilograms and kilogram equivalents. The remainder is sold through our traditional medical channel. The increase in kilograms and kilogram equivalents sold in the third quarter is clearly due to the launch of Canadian recreational market in the third quarter, offset by lower medical revenue due largely to the initial adjustment to the available legal recreational market, and additionally, the migration to the more relative medical product range, impacts that we feel are short-term. We remain bullish on the medical market in the coming quarters, particularly as more CBD oils are cleared for sale and become available online. The average price per gram of cannabis sold in the recreation channels was $6.96, and during the third quarter of fiscal 2019, the average price for gram in medical sales in Canada was $9.77, representing an increase of 19% over the prior year. And the average price per gram is international, which is really Germany at this point for medical sales was $13.28, up from $12.61 in the prior year's quarter.

Overall, during the third quarter of fiscal 2019, the weighted average sales price was $7.33 per gram, representing decline of 12% from same period last year. As I indicated just a minute ago, the average selling price declined in the third period -- third quarter relative to prior quarters due to the B2B pricing to the provincial crown corps in the recreation market.

In the third quarter fiscal 2019, the company harvested 7,556 kilograms, down slightly from last year due to timing of harvest, which were occurring in the -- in the current fourth quarter and with the larger greenhouses undergoing fit-ups in the early pilot -- early pilot harvest at Mirabel during the prior or just the third quarter, just concluded as well as we had 8 grow rooms in the Smiths Falls facility diverted to fulfillment activities to meet the recreational launch in October. With close to 2 million square feet of greenhouse in BC, Québec and Ontario licensed recently, including 1.1 million square feet license in early October to bring a total license platform to 4.3 million square feet, we expect the amount of cannabis harvests to increase in the coming quarters and reach product -- productive utilization.

Now turning my attention to gross margin. The cost of sales including the impacts of operating cost of cannabis cultivation subsidiaries not yet fully operational, including a Delta greenhouse and a number of zones at the Aldergrove greenhouse facility, both going through fit-ups as well as Fredericton and our greenhouse in Denmark also in their final inspection phases. Mirabel was also in its first pilot grow cycle last quarter, which combines the other nonproducing assets to result in higher temporary underutilized overheads or period costs. We expect to see Denmark beginning to supply European markets this coming September, and also to contribute to the margin. Cost of sales also included costs associated with developing and testing edible and beverage products for which markets will be available in calendar of 2019, later in the 2019.

Excluding the cost associated with these non -- not yet cultivating facilities totaling approximately $13.1 million, and medical excise taxes absorbed by the company of $2.1 million, the gross margin before the fair value impacts on cost of sales and other inventory charges would have been $33.5 million or 40% of net revenue instead of the reported $18.3 million.

On the medical excise tax impact, management decided to absorb the excise tax in order to ease the burden imposed on our patients. The company believes gross margins will improve in the coming quarters, but only as cultivation facilities reach full utilization and cycled through the initial pilot harvest to be high performing assets.

In addition, margins are expected to benefit when edibles and beverages are introduced later in calendar 2019 with lower cost and active ingredients per serving, all combining to drive more margins north of 50% in the coming quarters.

Next, turning for a moment to operating expenses in the fourth quarter and fiscal year. Sales and marketing expenses for the 3 months ended December 31 were $44.9 million, up by a little over $5 million from the second quarter of this year. The company made a strong push such as the high pop-up in billboard campaigns in the lead-up to October 17 when the cannabis act went into effect and then placed further restrictions on advertising and promotion.

As has been highlighted previously, the company continues to make significant investments across all the areas of our business to strengthen company's leadership position in Canadian grow medical market -- cannabis markets as well as for the recently launched recreational cannabis market here in Canada.

Sales and marketing expenses include costs associated with the development and branding, marketing, education campaigns, the development of new permitted product SKUs, such as pre-rolls, the development of recreational product packaging, the development of the cannabis retail as well as education programs and cost associated with company's medical outreach program. These expenditures represent the company's view that strong brand recognition is, over time, essential to the company's successful market share acquisition strategy, particularly in the new recreational market here in Canada. These costs represent a strategic upfront investment, which management believes will have a long-term benefit in customer acquisition and retention.

Further, the company is making these investments to aggressively seek new domestic and international business opportunities to build for the future. G&A expenses for the 3 months ended December 31 were $46.1 million. Management believes the foundational investments that Canopy is making across our corporate bench as well as in operations, IT, supply chain, finance, legal and the aforementioned sales and marketing area represented prudent long-term investment to strengthen our leadership position.

Both sales and marketing and G&A expenses were up significantly over the prior year's third quarter and the most recent second quarter, but management expects these expenses to level off in the near term, particularly in our Canadian operations.

R&D expenses for the 3 months ended December 31 were $5.3 million or 6% of net revenue. In comparison, R&D expenses from the same quarter last year was just $300,000 or 1% of net revenue. The company's R&D team is researching a variety of intellectual property opportunities, including those related to growth patterns under different environmental scenarios and the genetics of various strains. The development of patent-pending technology related to equipment that the company has engineered specifically for the cannabis industry and ongoing R&D work being performed in company's dealer license area is expected to lead to the development of new cannabis-based product form factors that will enter the market when permitted.

With the acquisition of Canopy Health Innovations, the distant scope of R&D being undertaken, and additional resourcing necessary R&D expenses were up significantly over the same period last year, and are expected to increase in absolute amounts over the coming quarters.

Acquisition-related expenses for the 3-month period ended December 31 was $4.5 million. And these expenses primarily related to the acquisitions of ebbu or the assets of ebbu and Storz & Bickel.

In addition, the acquisition related cost were incurred due to the ongoing evaluation of potential acquisitions performed during the period, and increased legal accounting and strategic business consulting services required to evaluate, negotiate and complete these transactions.

As we previously discussed, we expect to acquire additional strategic assets in the future as we pursue our business strategy.

The noncash share-based compensation expense related to options granted to employees and consultant of the company and to acquisition-related milestones combined for the quarter to total $63.9 million. The impact is all employees the company receive stock options as part of their compensation package, and I note that, we had 2,700 employees at the end of the third quarter as compared to 700 a year ago, and even 2,000 at the end of September.

Acquisition-related milestone payments based on future performance and related criteria have been treated as stock compensation expense instead of being allocated to the purchase price.

In comparison, the noncash stock-based compensation related to options granted to employees and consultants of the company and to the acquisition-related milestones and this combined in the same period last year was $17.9 million, again, 2,000 less employees a year ago.

Now I'll turn my attention to other expenses and net income. The other income was $235.2 million for the 3 months ended December 31, as primarily made up of fair value changes on financial assets and financial liabilities, and that includes a fair value gain of $186 million, arising from the decrease in the fair value of the senior convertible notes from the end of the second quarter to the end of the third quarter, and a fair value gain of $36.5 million of financial assets, principally the TerrAscend and Slang warrants.

The company also had a net interest income of $18.6 million on cash and marketable securities. This income was partly offset by a loss of $6.3 million as a result of the TerrAscend restructuring, which resulted in exchange of the TerrAscend shares for the non-voting, non-participating exchangeable shares under plan of arrangement.

Third quarter net income after taxes was $74.9 million or $0.22 per basic share. And as I mentioned earlier, due to the calculations involving the assumption of the convertible debt at the beginning of the quarter, it resulted in loss of $0.38 per fully diluted share. And that compares to net income of $11 million or $0.01 per basic and fully diluted share in the same quarter last year.

Next, I'd like to briefly review our supplemental non-GAAP measure, adjusted EBITDA. Adjusted EBITDA is defined as earnings from operations as reported before interest tax and adjusted for removing other noncash items including stock-based comp, depreciation and accounting for biological assets and inventories and then further adjusted to remove the acquisition-related costs.

We reported adjusted EBITDA believing it is a useful financial metric that will help investors assess the operating performance of our business before the impact of investment, acquisitions, income taxes and noncash fair value measurements. Adjusted EBITDA in the third quarter amounted to a loss of $75.1 million compared to an adjusted EBITDA loss of $5.7 million in the same quarter last year. The higher adjusted EBITDA loss is due to the matters I described earlier with respect to the nonproducing facilities, which are temporary and absorption of the medical excise tax, which was the conscious decision that we made to support our customers. And along with the investments committed in sales and marketing and corporate infrastructure to develop global opportunities as I also just described.

We believe our deliberate and ongoing investment in building the company's production platform, brands, international reach, partnerships and operations, which directly impacted our adjusted EBITDA during the period, is necessary to strengthen the global -- the company's global leadership position.

Now quickly turning your attention to the balance sheet and cash flows. As of December 31, the company had cash, cash equivalents and marketable securities available of approximately $4,915,000,000, up from approximately $322 million at the end of fiscal 2018. The net increase from the end of last fiscal year was due obviously to the investment of approximately $5 billion by Constellation Brands in November. June's issuance of convertible senior notes with an aggregate principal amount of $600 million, offset by cash used to fund operations as well as investments in facility enhancements that totaled $568 million year-to-date.

The company's excess cash resources are invested and governed back by liquid treasury bills and bonds, and a common now, actually, interesting that we're now banking with or investing through most every major Canadian bank, 5 of them as well as 6 major U.S. banks. You should also observe that the fundamental change notice issued in September on the convertible notes expired in early December without any holders exchanging the shares, so that the make-whole provision expired and the notes will remain outstanding at December 31.

Inventory at December 31 amounted to $185 million, up from $102 million at the end of March. And at the end of the quarter, biological assets amounted to $31 million, up from $16.3 million at the end of last year fiscal year.

Together, inventory and biological assets totaled $216 million at December 31, up from $118 million at the end of last year. Inventories are continuing to be scaled to meet management expectation and market demands, including a demand from the legalized recreational market and sufficient choice for our medical customers.

Management continues to be the soft -- significant demand will develop for cannabis oil and particularly, Softgels in the recreational market. As such, the company continues to increase inventories of extract-grade dried cannabis, held for conversion and increase the quantity of cannabis oil and Softgel caps that we have on hand.

And now I'll just take a brief moment to acknowledge the CFO transition that was in yesterday's press release. After much consideration over the past several months, I have made the decision to retire from the CFO role at Canopy, later this calendar year, and I informed Bruce, Mark and the board in December.

After being in this role for 4 exciting -- 4 very busy years, helping the company through an aggressive phase of growth with some 30 M&A transactions, and I won't say so far, multiple financings raising $6.5 billion in historic stock market listings, including the first for a cannabis company, on both the Toronto and New York Stock Exchanges. I really believe now is an appropriate time to hand the reins over to a new financial executive to shape and drive financial capabilities over the next 3 to 5 years as the company prepares for its next phase of growth.

I have to say, I love being CFO at Canopy Growth, working, with Bruce and Mark and the Canopy team, but, with the personal commitment I gave, there is a toll on the family and it's important for me to make my family a higher priority.

The company has already initiated a search for my successor, which Canopy has identified, and we expect that person would be named in the coming months. I wish to stress that following the transition to successor, I very much look forward to continuing to serve the management team and the Board of Directors in strategic adviser role to help drive Canopy's future growth.

The experience I've had working with this dynamic team, helping build this company and this new sector has been a once-in-a-lifetime experience. I've often said, I feel like I joined [Siemens] in 1933. It's just been a fantastic opportunity.

So the next phase, we'll continue to see we go hard for Canopy Growth out of fun, and as we say here, we will get (expletive) done.

So this concludes my review of the financials for the third quarter. And I will turn it back to Bruce for some closing remarks. Bruce?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Great. Thank you, Tim. Just a couple of additions as we lookout. So Tim has isolated and highlighted on the investments we make and how those are coming on to yield, so in candor, we'll see that shortly. He touched on Denmark. We will begin, over time, as you've noticed our reporting to become more detailed and broken out. We're going to target giving you a picture, over time, meaning this year, which will give you visibility of how Canada, as an instance, is operating and the appropriate allocations for that as one of our goals on a reporting for the investors. But I do want to highlight that the objective of creating platforms will have other jurisdictions, which will use cash, which is why we have cash. As far as the U.S., and I hope there's some questions on it, we have identified the site and locked up the site in the New York State area with a couple of other backup options. We've had very productive discussions with the regulators. Our license and the platform we're building out as well as some incremental pieces that we think would fit together. So the U.S. action is moving quite quickly.

Our Latin America activities haven't had as much visibility because we've been, I guess, eligible to keep them a little quiet, but that group is now about 70 people operating across 4 countries with production assets well underway in construction, which will start to show up as real, I'll call it, both assets and yields over the balance of this year.

And I think now we could probably jump to some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question will come from Tamy Chen from BMO Capital Markets.

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

I was just wondering on your average selling price for the rec channels, almost $7 a gram. First, could you confirm is that gross or net of excise tax? And I was also wondering if you could elaborate a bit more on exactly where and how you're seeing this strong pricing in the wholesale channel?

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

Yes, all of the average prices are, or as quoted are net of sales tax. So that's after the excise tax is taken out.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

And where we're seeing Tammy, the most active selling points aren't correlated directly with the per capita number of people in the province. It's strongly connected with those places that have stores, and we expect in circumstances like Ontario will have stores that, that is a driver on people being informed in. So we've put quite a lot of time and money into our education platform. I think we've educated over 600 people who work in the cannabis sector as salespeople with a self-paced training program, which means that the customer walking in is much more informed, and I expect the average price over time, meaning by Q4 to actually increase because the format and the stores will have much higher-end products, including, we expect beverages, which when you get into our vape products, which we have been putting away oils for and building technologies for and our -- whether or not we get to make edibles of some sorts, we've worked through a variety of platforms and the beverages all of those we expect to drive to a higher margin per actual gram sold because of the other adjacent ingredients.

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

So my understanding was that for many of these provinces, it was the provincial crown corp that was the wholesale buy. And so I thought pricing was through a -- more negotiated processes and so it's just surprising that it's such a strong pricing that you're seeing. So are you saying that in certain provinces, is there like a sales that are directly to retail or...

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

No. So the provinces negotiate them and then the volume that goes to the province has connected to the point of sale the provinces have. So we're seeing strong sales in provinces like Alberta with more retail, and we expect the same to be increasingly true across the country as more stores open up, so it's to wholesale. Then after that, we have certain circumstances where we actually also then have a point of sale, think of Newfoundland or Manitoba or Saskatchewan and coming up with Alberta. Now in that model, what we sell wholesale has been originally it was bulk cannabis dried, as the quarter ended it included gel caps. We've now launched our roll joints, and I think our sales of those units are well through 50,000 units. But what we like about them is we now make them in 1 gram, 0.5 gram and they are made on extreme narrow-tolerance platforms, which we had to create and then file patents on. And so those produce upwards of 10,000, call it, units we can produce in an hour, so now we're looking at how do we use that equipment in a variety of other locations that might make sense, if you could export the technology. So I think you're going to see the average margin go up as more and more of these products hit where the model is to the provinces and then through the stores.

Operator

Your next question will come from Vivien Azer from Cowen.

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

So I want to focus on the top line group. And so when we spoke last quarter, you're confident in reiterating your confidence in incentive for the back half of fiscal 2019 and incentives have come down, so the third quarter was in line, but your production in the third quarter declined potentially relative to 2Q. So how should we think about the 4Q relative to 3Q?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Okay. Guess, we're not giving exact EBITDA or top line, but we do have inventory growth, and we have harvest some called it the timing of the harvest. So really we're comfortable. We have the products that will get to the number. What we're always looking at is, where is the demand? Who's getting the stores up? What's the sell-through like? But we think, we do have, in fact, especially, as oils are becoming presented as a more significant portion, and what we think of it is a bit of a backlog for exports to places like Germany. We're not pushing down or up on what we're looking at for the balance of the year.

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

Okay, perfect. And then just a follow-up on revenue. When you spoke at the CAGNY launch in New York in December, you articulated that you believe that you'd have the CBD products in the U.S. commercially available by end of calendar 2019. Just wanted to see if that holds number one, and then number two, on CBD in your revenue outlook, you recorded in an interview, a week or 2 ago, saying that you were open to investing as much as $500 million against the U.S. CBD opportunity. And I just wanted to understand your thinking around that, because that seems like an awfully big investment for a market that I believe only generated about $500 million or $600 million last year?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Yes. So a couple of things, we have put our -- where we're going to be in New York state in large part, because of the regulatory framework New York states put in. People may have noticed a week or more ago where the regulators are starting to, at a New York state level enforce the fact that CBD is something which needs to have proper claims, proper processes, source of access that's actually traceable. So I think New York State is going to be a strong market right now. Would we have it in Q4? I think, we're still on a track that would expect to have products in the markets where they are permissible. So may be New York state will be a terrific market, perhaps California will be a tougher one, and that's more about regulation. But we are on track with acquiring the building, having third-party growers, having processing and whether or not it's Q4, Q1 it's a function of a few things having to go right, but that's our timeline. As far as the total investment, we think they're going to be multiple states we have to operate production and processing of hemp. And that they'll be industrial park scale. That asset group and the channel we sell-through will lend itself extremely well to cannabis, if and when. And so we view these investments as creating a lawful channel to a large box and a corner store sale point of products that are disruptive to source recovery through cosmetics and certain medical fields. But the asset group has a lot more extension over time, which could be activated very easily if state is right to the goal.

Operator

Your next question comes from Michael Lavery from Piper Jaffray.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

As you talked about looking out 5 to 7 quarters, how should we think about the margin and earnings piece of that? And what sort of trajectory this looks like?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

So as we kind of touched a little bit, we're going to try to give you very good visibility on the earnings by country, by category, meaning medical rec and product type. So that we can actually help you the analysts and investors understand the yield potential on the invested assets in a country like Canada. And then what we wish to do is back out and normalize investments that we're making intended to be globalized. So Tim will speak to the margin opportunity on a country like Canada, but you will see batch laid down, meaning investments in assets that are in geographies that are beginning medical programs at a federal level with the population sufficient to return in that country on the invested capital without exports. So Europe, as a region, we have a strategy of investment that covers 4 countries, South America, 4 countries, Australia. And each of those will have yield that goes out over anywhere from 1.5 to 3 years. Tim, I don't know if you want to speak to the margin that we are looking at, but it is a sequencing of a creation of a very good business in Canada to reflect all the jurisdictions where we think it can go.

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

Yes. So we already commented that, we had some nonproductive assets in the last quarter. This is intentional in terms of what we hit outside the BC Tweed, the 2 Aldergrove Delta facilities and like you've said Mirabel was really just going through its first grow, which we call it a pilot grow. So those are now well and planted and growing and harvest is planned in fourth quarter. And I think you'll see that we continue to improve the yields and, therefore, utilization. So those margins will definitely move up as we get the 4 -- almost 4.7 million square feet of greenhouse and later about a million square feet of indoor ground being fully productive that's just in Canada, of course. And then you get -- as we've mentioned earlier Denmark coming online later this year. So getting a full utilization will remove all of those costs that are hitting the markets today. And at the same time, you get to the other form factors that we talk about -- or I'm sorry, the edibles and beverages. And also, I think, you see the medical market while there was some cannibalization in the last quarter. We also believe that this will come back strong and those will attract higher average selling prices. So all I can say is that we set a northward march on those margins so that you get in the mid-50 range or plus in the quarters that are coming.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

So what was the last part, you said the mid-50 range of investment margin?

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

No, net revenue. Net revenue margin.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Oh, net revenue. And just on the margin side, as you look at your, call it, 5 to 7 quarter planning horizon. Would you still imagine the total company picture to be investment mode and growth mode more than you should be thinking about any kind of positive earnings coming out?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

You will see a model for Canada as a function of, otherwise, regulatory turn up. How fast does it happen in America would obviously affect how much we're putting in. And how fast the transition is, and we think it's happening quite quickly from what was called medical marijuana to what we think of as cannabinoid therapy. And so the opportunity, if the IP results from our trials in Canada that some of them are expected to have the potential for claims as early as Q4, that does start to put quite a bit more potential for margin because you're no longer selling medical marijuana, you're selling outcomes on the cannabinoid therapy. So the walk-around that I guess would say it depends on what happens on a regulatory basis. But we see a very good line of sight in Canada and Europe, America is the big unknown at this minute.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

And is that calendar or fiscal Q4? That's calendar?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Calendar for the trials. Trials do have the ability to go slower or faster, but some of the work that we're doing on the Phase IIb for human and some of the work on dogs, the current schedule we'd look at the calendar Q4 for initial results and ability to make claims or not. So these are not decades-out kind of activities.

Operator

The next question comes from Martin Landry from GMP Securities.

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

If we want I'm going to assume Martin's question was about margin, but I don't know if we want to take the next question.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Hi sorry. I was there. So my apologies. It is on the production costs and margins, actually you're right. Just wanted to dig a little bit further into -- when you say that we exclude your noncultivating assets, your gross margin is around 40%. Your average selling price is $7.30. So that gives me a production cost of around $4, $4.25 a gram. It looks a little high. And I'm surprised that it's not trending down. You have large facilities now in production. Can you explain to us a little bit better what is embedded in that cost and why it's at that level?

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

Yes. So I mean it's like I said we're between Delta, Aldergrove and Mirabel. They are not producing a product that is actually being sold. There is the operating cost, still there is -- still being incurred during the quarter and those costs go right to the bottom line without the benefit of getting production out of it. So essentially your denominator like there is no denominator of grams produced in those periods while you are doing fit-up. So that -- it's a bit of an artificial number that is being created to come with a cost per gram because it's not apples and apples. When those assets are fully producing all those costs, we match against production and eventually get a lower cost per gram. So it's just a quarter that we had to invest in, and make these changes in the facilities. So they can be up and running and producing high-yield plants.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

And Tim, maybe additional color to that, we're seeing at the end of this month and into next quarter those harvests are actually coming off of a larger platform. So when you picture greenhouse, it's not 1.7 million square feet. I know, you've been at the Montana. But for others on the call, think of it as 5 to 7 zones. And what you can't do is plant it all the first day and then harvest it all the next, it is 9 weeks later. So it's a rotation of getting all of the zones both retrofitted and then into production. So it is the continuous flow harvest. And the good news is, most of that investment is complete and the continuous flow harvest equipment has been thought through and some of the patent protected seeking. And the supply chain is near the top of the cycle to start producing out the 2. The exception to that is our Newfoundland facility is the furthest out from completion, but we're looking at something there that's in August, September, but otherwise New Brunswick, BC and Québec are largely finished with the next thing being extractors, not actual production assets, but conversion assets.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

Okay, okay. And then maybe just switching gears. You're realizing a very high selling price internationally, and I'm just wondering at this point, what prevents you from shipping more products internationally?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Excellent question. So last quarter, there were a lot of changes and the regulators were pretty busy and so were we, so getting actual approvals through was not as fast or smooth as normal course. I believe we're returning to normal course and in the interim there is quite a lot of demand in those geographies. So as around Q3 it was pretty crazy and being a regulator, and a producer, both of the parties were, I would say, full up but that has been a priority we've been focusing on since January with the regulator to increase the volume that we can ship while continuing to fill all the channels in Canada.

Martin Landry - *GMP Securities L.P., Research Division - Director and Equity Research Analyst*

So it's not a case of production not being available? It's just more a function of paperwork?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Yes, so each time you ship, it has to be requested by the foreign jurisdiction, approved by the Canadian jurisdiction and the product has to be available to go across. Principally, it has been the paperwork, not the product. And I think we're highly focused on the paperwork and the product being available this quarter and next.

Operator

Next question comes from John Zamparo from CIBC.

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

I want to follow up a bit more on that U.S. CBD opportunity. Encouraging you expect to have these products in by Q4. I was hoping maybe you could share what some of your most impactful products would be? What retail channels you are prioritizing and just generally, can you talk about your discussions with the FDA and regulators in the states outside of New York?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Those are all great questions and I have to think that if I give a really clear full answer that would be advantageous to parties we're not here to help. So when we look at who is interested in speaking with us, it goes from big box to corner store. What product producers it goes from, things that people are already selling into cosmetic to animal care. And we've announced our intent on trials in the dog area and there are, we think, capacity to create a range of products. We are going to be selling finished goods that are powered by and, in many cases, branded by divisions that you would call health and wellness. And so the FDA file has been and being developed, but the regulation is also a state level lead in a place like New York. And so this was about a great launch platform with very good regulators that lead to a medium-term FDA file that we think will be quite helpful, but we don't have that and need it to start New York. And we have a very skilled and substantial team, which included people we took from Green Star Constellation and really key people in our organization and hires that are all U.S. focused and on this file. So it is a really live, really active file and lots of moving parts, but I think it will have a potentially serious impact before the year is out.

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

Okay, that's useful. And I wanted to follow up on a comment you made at the beginning of this call, Bruce, about moving to Phase IIb of the clinical trials for insomnia treatment. When might we see commercialization of this? And is the more likely result that you have new product to treat this or is it -- is the benefit that you have now legitimate claims that your existing products can treat it?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

So it's claims on dosage and a uniqueness potential protectable on delivering mechanisms. And it becomes a platform by which you can then increment and adjoin what we have with perhaps other claim-based inputs. And it allows people to go to a doctor and say, "See, I told you. In fact, it does work and I would now want to have access." So I think it moves the needle on legitimizing I think what many people understand is that from our observational connections with our client base the second most common reason they are acquiring cannabis is to fall asleep or stay asleep. And if we can turn that into a form factor delivery mechanism and then a science set, you really do move the needle. And it is just the first effort with a drug master file and stabilized ingredients that can add whole bunch of other trials on behind, and we have a dozen plus that are mapped out and rolling up. So it's a lot of leverage for the patients. I think it gives us a really good platform product to go out with. And nobody really does love the current sleep options.

Operator

Your next question is from Oliver Rowe from Scotiabank.

Oliver S. Rowe - *Scotiabank Global Banking and Markets, Research Division - Associate*

Looks like you achieved a 30% market share in the recreational market this quarter. I think that's in line with your target, and it's in line with mine. So my question is as other producers catch-up in terms of bringing production online, is that a target you expect to be able to hold? And is it one you think you can bring into the international markets as well?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Well I think within 2 calls, we're going to hardly talk about production, and we're going to talk about conversion and conversion into what. And where we've made really significant and thoughtful investments has been to be in the conversion and creation of products that create customer demand and brand that wins. And so I would be, kind of, upset if we can't maintain or improve because we're far enough ahead and have been thinking that way and working on things for 3 to 5 years that I think are just going to be ready to take hold in the next 3 to 7 quarters. So I hope someday people don't even want to know about how did you grow that because that's really a necessary step, but it's not the core focus. So yes, we should dominate, and I will be extraordinarily disappointed if we don't do that through science and claims and products.

Oliver S. Rowe - *Scotiabank Global Banking and Markets, Research Division - Associate*

So as a follow-on from the conversion angle. You've recently inked deals with third-party extractors. Could you discuss why you are moving a portion of that business out of house and if this is more of a temporary measure as you bring your own facilities on, or is there a structural benefit to doing that out of house?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

It's really an accelerant to the opportunity at hand. Our platform that we're building is quite a lot larger and more scale. And some of its co-located with large production grow green houses. So we just thought these were very useful sources of conversion. I bet there'll still be business with them to fill gaps. That overall model, I think, is a very thoughtful place for people to have created value. But it's certainly not a core move out. We really have put a lot of IP effort on how do we get to API level of extraction. And so this is a really smart way to get a little faster now.

Operator

Your next question comes from Graeme Kreindler from Eight Capital.

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

I wanted to ask about the U.S. market. Flipping through the MD&A here and understanding that the company doesn't want to invest in any company -- or I shouldn't say invest, operate in any country where it is not federally permissible to operate cannabis. The MD&A mentioned the STATES Act as a framework that they think would allow cannabis to be federally permissible. So my question is with something like a safe act that reconciles banking, does that give you an accelerant towards potential investment or a strategic partnership in the U.S.?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Yes. So anything and there's many variants right now floating around, some are bipartisan working through and our lobbyists and crew are watching it. Anything that would allow at a state level the activities that currently occur in the state, not to be off-side federally. And as a result enable parties like (inaudible) to see it such that our listing would be maintained. Immediately means that we are in. And so there are a bunch of formulations that could result in us being able to immediately enact our plan in any of those states. It's feeling much likely -- more likely that it's sooner than later, but it's politics. So hopefully, that helps, Graeme.

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

Okay. And then just another question here. In terms of preparation for the edible ingestible derivative market and looking at the inventory balance at the quarter end, 65% of that balance is work in process inventory. How is the preparation for the products in that market being handled while balancing also validation in the Canadian channels as well as internationally?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

And what's your demand for cash in Q4 of this year? So we are, we find that oils are an extremely likely stabilized ingredient to fit into everything from beverages to edibles to vapes. So we're working on accumulating oils, part of the prior question on why are you using these guys is because you need to have it in a state where you can actually then opportunely convert it to where you want. I don't know if you want to speak to allocation, but it is a continuous active juggling act with first to get it is science, second is patient, third is export, fourth is rec. And it's a constant -- our Canadian COO has a full-time function of allocation. Tim, do you want to speak to anymore?

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

No. That's exactly it. The operations group constantly looking at supply-demand forecast, and allocating, what do we need the variety and formats. And so they think about that sort of every day in making those allocation decision.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Yes. And so like this is not a stockpiling exercise at all. And we're constantly looking at as the provinces are turning up more stores, we need to fill that warehouse. I think we're doing a solid job, but I would say that effort to continuously deal with allocation of the scarce resource is a top 3 priority in the company.

Operator

Your next question comes from Matt Bottomley from Canaccord Genuity. Okay, we'll move on to the next question from Mike Hickey, The Benchmark Company.

Michael Joseph Hickey - *The Benchmark Company, LLC, Research Division - Research Analyst*

The first quarter of adult use is pretty awesome.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

And I can confirm that it was a unique operating environment, a very unique operating environment.

Michael Joseph Hickey - *The Benchmark Company, LLC, Research Division - Research Analyst*

That was. Curious on sell-through. What are you seeing in terms of consumer demand for individual SKUs, if there is any stand-outs and maybe in particular, the demand that you are seeing on adult side for Softgels. And then I'm not sure how much visibility you have on sort of the legal framework that's taking shape around edibles. But would you expect to have gummies or chocolates, as possible product SKUs?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

So few questions there. I would say on the data for what's selling through, really, we were getting into December and January, when we're actually launching in all of the Softgels that we could across the country and pre-rolls. So I think I'll be able to give you a much more accurate and crisp answer as we finish the fourth quarter because we'll have pretty much 1 full quarter. Everything that we can make whether it's chocolate to drinks, we have been building out a platform so the people who have been to our site have observed the internal chocolate factory that exists and the bottling plant that exists, and we've been doing a lot of testing and working through various formats. It's all going to come down to regulation. And so the regulations right now, it's still speculative as to I don't know, how the cap must work on a bottle for a closure versus whether or not the glass is colored. We will have every format you can contemplate, but they are right now functionally driven by what the regs say and the regs are coming to their final form. We have been waiting for the regs to get ready, but that will affect what we have to put in the market and if it's -- if it's legal, we'll have it.

Michael Joseph Hickey - *The Benchmark Company, LLC, Research Division - Research Analyst*

And then do you have a sense of how draconian the packaging is going to be on some of the edibles? I mean, do you feel like maybe there is going to be a list of what you have done on the flower side?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

Yes, just for everybody on the call. The packaging from our perspective is okay. What we're more concerned about is the quantity and weight and the fact that from a recycling and consumer preference, we wanted to launch with great packaging, we've done that. But we're really pushing on packaging, enabling this to be something that has some appeal, but for sure has some functional benefits, over what is currently there. And you are seeing it, right, in the debate over how does a closure work on a bottle versus a can. It's getting tighter. We got out of the gate. Everything was okay, too good, and now it just seems like it's going to keep getting better. Keep your containers, they may be collector items fairly soon.

Why don't we take one more call if there is one. And then I think everybody probably has a job related to the market.

Operator

I have one from Andrew (inaudible).

Unidentified Analyst

So a quick question for you on the medical side. Obviously, it was under a lot of pressure in the quarter. Can you give us any clarity of a lot it's been obviously the transition out of Spectrum. Can you give us any clarity how Spectrum has kind of performed? How it was doing last year? How many doctors adopting, things like that?

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

So Spectrum has become our formal brand for all medical, everywhere in the world where that transition in Canada started to really take shape in calendar -- like calendar Q2 last year, where you started to be registered, in part that was driven by provinces that didn't wish to have Tweed medical and Tweed's rec. The Spectrum can be health education on that. Current actual number of doctors writing, I couldn't give you an exact number. Total number in Canada that have written in our sector appeared to be about 20,000 with more referrals from other docs. Our pacing count, Tim, I don't know if you have it at your fingers, but it's in that sort of 80,000 to 100,000 patients. I think would be a range, for I don't know, Tim, if that's...

Timothy Rob Saunders - *Canopy Growth Corporation - Executive VP & CFO*

So we're just, about 83,400 patients. So just down slightly from where we were in Q2, but I think it's pretty mature to make a decision that we do believe that, that will continue throughout.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

So the medical platform will, I think, accelerate now that the people can have frank discussions with doctors, now that rec is there. And they don't appear to be looking for a party, but a solution to their health. I think with the testing platform we're putting out like I am -- I continue to believe that our medical opportunity on a global basis over the next 3 years potentially has the top line bigger than the rec because there are going to be so many more people governed by it and the products are going to actually evolve to be in cannabinoid therapy not medical marijuana. So it is a big focus and a basis of optimism for what's next for us.

Operator

I have no further questions. Thank you. I turn the call back over to Mr. Linton for closing remarks.

Bruce A. Linton - *Canopy Growth Corporation - Co-Founder, Chairman & Co-CEO*

No, that's great. Thank you, everyone, for your time and questions. Thank you, Tim. You did a fantastic job. And we look forward to next quarter and doing this again.

Operator

This concludes Canopy Growth Third Quarter Fiscal 2019 Financial Results Conference Call. A replay of this conference call will be available until May 14, 2019 and can be accessed following the instructions provided in the company's press release issued earlier today. Thank you for attending today's call and enjoy the rest of your day. Goodbye.
