Acreage Holdings

Fourth Quarter 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Steve West - *Vice President, Investor Relations*

Kevin Murphy – *Chairman & Chief Executive Officer*

Glen Leibowitz - *Chief Financial Officer*

PRESENTATION

Operator
Good morning, and welcome to the Acreage Holdings Fourth Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. Please note, today's event is being recorded.

I would now like to turn the conference over to Steve West, Vice President of Investor Relations. Please, go ahead, sir.

Steve West
Good morning, everyone and welcome to the Acreage Holdings fourth quarter and full-year 2019 conference call. Joining me today are Kevin Murphy, our Chairman and Chief Executive Officer; and Glen Leibowitz, our Chief Financial Officer. This call is being recorded and will be archived on our Investor Relations website at investors.acreageholdings.com.

Today's call contains forward-looking statements, which are subject to various risks, uncertainties and other factors that could cause our actual results to differ materially from those forward-looking statements. Any such statements should be taken in conjunction with cautionary statements in our press release and risk factor discussions in our public filings that can be found on SEDAR and EDGAR, as well as our investor website. Any forward-looking statements speak only as of today and we assume no obligation to update them.

Now for your future scheduling purposes, our first quarter 2020 earnings release is tentatively scheduled to be issued after the market close on May 12. And our earnings call is tentatively scheduled for the morning of May 13, 2020.

I will now turn the call over to Kevin.

Kevin Murphy
Thank you, Steve, and good morning, everyone. 2019 for the cannabis industry can best be described as a roller coaster, full of ups and downs and unexpected twists and turns, which we discussed in-depth last quarter. Our internal operations were challenged by significant regulatory hurdles at the local and state level. HSR reviews by the justice department caused further delays for all major transactions in the cannabis industry this past year.

Despite the challenges we faced in 2019, I'm proud of the dedication and professionalism of all of our Acreage employees in helping us deliver on the shareholder promises that were in our control. We ended 2019 with 30 operational dispensaries and an additional 8, which were 100% construction complete, but not yet operational due primarily to awaiting regulatory approvals. These 38 operational or construction complete dispensaries were within our full year dispensary guidance of 35 to 45.

Sales at dispensaries opened for more than a year showed tremendous growth. In fact, our 2019 pro forma same-store sales comparisons were up more than 40%, driven predominantly by positive transaction growth. I'm pleased to report the core health of our retail business is very strong.

During the year we began launching our house of brands across our national footprint. And the reception by industry professionals and consumers far exceeded our expectations. The Botanist and Natural

Wonder received high praise from Cannabis Now, a leading cannabis industry publication for their showing at the Hall of Flowers event last fall.

Additionally, the Botanist and Live Resin Project won awards in their respective categories at the prestigious Emerald Cup brand competition. In addition to our internally developed brands, we launched Canopy Growth award winning Tweed brands. We are currently retailing and wholesaling Tweed branded flower in Illinois, Maine, Massachusetts and Oregon. While there is still much work to do to achieve national brand status, I could not be more pleased with these accomplishments.

During 2019, we made significant progress in building our wholesale business. As discussed on our last earnings call, our prime branded medical products achieved 100% retail distribution in Pennsylvania. Nevada, Deep Roots has nearly 80% retail distribution and in Illinois, we are wholesaling into nearly 50% of retail dispensaries. We ended 2019 with a pro forma wholesale revenue mix of 16%, which was a significant increase from our 2018 ending sales mix of 6%.

Capital access in 2019 and thus far in 2020 is arguably the number one issue facing the cannabis industry. During the fourth quarter, we closed on an initial sale-leaseback transaction of $19 million with potential for future transactions. More recently, we announced a series of comprehensive financing transactions, giving us access to up to $150 million in capital. We are continuing discussions to raise additional capital to meet our long-term requirements and position us for more long-term growth.

Before turning to our 2020 outlook, I want to note that the year is already off to a fast start. In Illinois, we began selling adult-use cannabis through our wholesale channels and our pre-existing medical dispensary in Rolling Meadows.

Additionally, we are slated for Zoning Board review of our Chicago dispensary in March and if all goes well, we are targeting the opening of our second adult-use dispensary in the second half of the year. And finally, as announced yesterday, our partners in New Jersey opened their second medical dispensary, a Botanist on the iconic boardwalk of Atlantic City.

Looking ahead, at the rest of 2020, I will lay out the overall strategy and Glen will provide some specific color in his remarks. The overall strategy for 2020 will be driven by two key revenue initiatives in wholesale and retail, leading to significant top line growth. Our rate growth strategies will be complemented by a cost-cutting initiative focused on G&A savings and margin improvements, which we have already begun implementing.

And finally, our 2020 CAPEX spend is designed to deliver improved returns on invested capital in relatively short order, while positioning us for long-term success. We believe these four key initiatives will set us on a clear pathway to achieve positive adjusted pro forma EBITDA in 2020. With the intense focus on access to capital, and even more importantly, capital allocation, we are shifting resources more towards brand building and wholesale operations, while still expanding our retail footprint.

Wholesale and branding front, we will focus on two primary growth drivers. First, we will significantly increase our production and processing capacity and capabilities in key states. We will continue building new cultivation and processing facilities in states such as Florida and Ohio, and also expand existing facilities in states, where adult-use is already legal or expected to be legal in the near future such as Illinois, New Jersey, New York and Pennsylvania. These investments in our production and processing capabilities will account for the majority of our 2020 CAPEX spend.

Second, we will continue the national rollout of our award-winning branded products such as the Botanist and Live Resin Project to more states and expand into more form factors where allowable by law. Specific to Tweed, we will continue that expansion both in terms of increased states and form factors.

In the first half of the year, we expect to increase the number of strains of flower, we offer in our retail dispensaries. As more capacity and supply are developed, we will also increase the number of form factors to include pre-rolls and vape cartridges. And in the second half of the year, we plan to expand our Tweed branded offerings into additional states broaden its existing coast-to-coast presence. We believe focusing on these two areas will lead to outsized wholesale growth and support our national brand building efforts throughout the US

Our second revenue growth strategy is in retail. We will continue to build out our existing dispensary footprint for deeper penetration in states, where we have existing operations and of course a significant build out in Florida.

For Florida specifically, we will sequence our dispensary openings to coincide with product availability throughout the year. At any given time, we will likely have several stores 100% construction complete, but not opened, pending supply availability to meet expected consumer demand. Until our Sanderson facility is fully operational, we will use cultivation pods to develop our dispensaries and supply them, while exploring other options as well. We believe a measured opening of dispensaries to correspond to supply availability is prudent from a long-term customer loyalty perspective and preserves cash and resources in the short term.

In addition to these top-line growth initiatives, we took a critical look at our cost structure to optimize our spending and accelerate our pathway to profitability. These cost optimization efforts are focused on G&A, including staff optimization, and other redundant administrative expenses. We believe our top-line growth initiatives combined with our expense optimization and disciplined capital allocation efforts should allow us to report positive adjusted EBITDA in the back half of this year. Achieving positive adjusted EBITDA in 2020 is the primary goal for the entire company and is aligned with both our Board of Directors and our executive team.

In fact, the KPIs for our executive and employee compensation are 100% aligned with executing and delivering on these goals. While 2019 was a year of many challenges in the cannabis industry, 2020 is setting up to be a banner year for Acreage, and I could not be more optimistic about our long-term future.

That concludes my prepared remarks and I will now turn the call over to Glen for his financial discussion.

Glen Leibowitz
Thank you, Kevin and good morning everyone. Last night, we reported our fourth quarter and full-year 2019 results. First, as we've discussed in our third quarter call, we are now reporting our financials in accordance with US Generally Accepted Accounting Principles which led to some changes in historic reported items.

While we presented the summary of significant US GAAP impacts in our detailed earnings slides published last night, I wanted to note that under US GAAP, a portion of our lease expense is now considered an operating expense, while under IFRS, it was reported in depreciation and amortization. This means our EBITDA is notably lower under US GAAP accounting rules versus what we reported under IFRS.

For the full year 2019 US GAAP results we just reported, there was approximately $6.5 million included in our G&A as rent expense. We will not adjust our reported EBITDA for the lease accounting change, but to help analysts and investors conduct peer-to-peer analysis, we will call out the lease expense impacting each quarter as a footnote in our financials. Additionally, to help support our financial analysis, we disclosed all four quarters of our 2019 US GAAP profit and loss statement in our detailed financial slides.

And one last administrative note, given the recent financing transactions, we announced and pending work yet to be done, we are targeting a filing date of our SEC Form 10-K on or about March 18.

Now, on to our financials. Our reported fourth quarter revenue was $21.1 million, an increase of 101% versus the comparable period in 2018 and full year reported revenue was $74.1 million, up 251% versus the full-year 2018. These increases were primarily driven by retail dispensary and wholesale business growth, including significant growth in our New England and Mid-Atlantic operations from a geographical perspective.

I'd like to note that our fourth quarter reported revenue deceleration slightly versus our third quarter reported revenue. And as indicated in our third quarter earnings call, we took advantage of an opportunistic wholesale transaction in Massachusetts during third quarter, which did not repeat in the fourth quarter.

Additionally, given the continued regulatory hurdles, we were not able to open as many dispensaries as we had planned which delayed the timing of anticipated revenue that we had expected.

We view this as a timing issue versus anything systematic. And as Kevin noted, pro forma same-store sales comparisons for the full-year 2019 were more than 40% and the fourth quarter was in line with our full-year growth rate.

The fourth quarter gross profit was $7.8 million which declined versus the third quarter gross profit of $9.7 million. Gross margin for the fourth quarter was 37.1% which was down versus the third quarter gross margin, 43.3%. These sequential declines in gross profit and margin were driven primarily from non-recurring opportunistic wholesale transactions in Massachusetts as well as pressure from Form Factory which is still ramping.

Moving to adjusted and pro forma results. For the fourth quarter, managed revenue was $32.2 million and our pro forma revenue was $43.6 million, up 100% and 90% respectively versus the comparable prior year period.

For the full year 2019, our managed revenue was $110 million and our pro forma revenue was $155 million, up 231% and 101% respectively. These increases were primarily a result of acquisitions in organic growth.

Our fourth quarter adjusted EBITDA was a loss of $18.3 million and our pro forma adjusted EBITDA was a loss of $15.8 million. For the full year 2019, our adjusted EBITDA loss was $55.2 million and our pro forma adjusted EBITDA was a loss of $44.4 million. While our losses accelerated on a sequential basis, during the quarter, we expect these results to improve going forward.

Moving on to the balance sheet, we ended the year with $27 million in cash and cash equivalents and during the year in 2019, we deployed approximately $204 million in capital for M&A including $110 million of equity issued and $94 million in cash.

Additionally, in 2019, we invested nearly $47 million in CAPEX to build out our footprint and advanced an additional $37 million to our partners with which we have managed services and consulting or other agreements with.

As Kevin discussed, we recently announced a series of comprehensive financing transactions to address our short and medium-term requirements while we lay the foundation to raise additional capital to ensure our long-term success.

Before moving to our 2020 targets, I'd like to set the bar where we landed at the end of 2019. We ended the year with 30 operational dispensaries and an additional eight that were fully constructed but not operational.

Of the eight fully constructed dispensaries, seven we're awaiting final regulatory approvals while the eighth, located in Spring Hill, Florida, we have purposely delayed opening until we have enough supply.

Now moving on to our 2020 operational and financial targets. In retail, we plan to build out 10 to 15 new dispensaries ending the year with 48 to 53 operational or fully constructed dispensaries. Most of our new dispensary build-outs will be in the Florida and will be back-half weighted.

In our wholesale segment, we continue to increase focus, which will lead to continued outsized growth versus our retail segment and we anticipate our wholesale revenue mix will be about 20% for the year, up from 16% in 2019. With respect to operational expenses, as we announced last night in our press release, we initiated a cost-cutting program focused on G&A, including staff optimization and significant cuts to travel and other expenses. We anticipate these savings initiatives will deliver approximately $7 million in annualized savings or approximately 12% of our reported G&A in 2019.

We expect total CAPEX of $45 million to $50 million, the majority of which will be used to build new and expand existing cultivation and processing facilities in key states. To that end, we expect to utilize sale-leaseback transactions for some of these cultivation facilities to provide additional cash and reduce our need to raise additional capital for these build-outs.

And finally, as Kevin discussed, we expect the culmination of these financial and operational targets to accelerate our pathway to positive pro forma adjusted EBITDA in the second half of 2020.

That concludes my prepared remarks. I will now turn the call over to Kevin for his concluding comments.

Kevin Murphy
Thank you, Glen. Before opening the call for questions, I want to briefly comment on our legislative outlook. While Capitol Hill remains locked in partisan quagmire, the states continue to legalize both medical and adult-use cannabis programs.

In addition to the New England and Mid-Atlantic regions, openly discussing adult-use legislation, several new states are in the process of legalizing medical cannabis programs. In fact, we expect as many as 40 states could have legalized cannabis programs before the end of this year.

With these additional states, it is quite possible that 80% of all states in the US plus the District of Columbia will have legalized cannabis programs. Congress must wake up to this avalanche of support and get in step with their constituents as the overwhelming majority of this country approves the legalization of cannabis.

As momentum continues to build, I am more optimistic with every passing day that Congress will take action. Finally, I'd like to thank our Acreage associates across the nation for their hard work and dedication in helping us deliver a cannabis to those who need it.

With that I will have the operator open the line for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question you may press star and then one on your touch-tone phone. If you are using a speaker phone, we ask you to please pick up your handset before pressing the keys. To withdraw your questions, please press star, then two. We also ask you to please limit yourself to a single question. If you have follow up questions, you may requeue and we'll take your follow up as time permits. At this time we will pause momentarily to assemble our roster. And today's first question comes from Aaron Grey at Alliance Global Partners. Please go ahead.

Aaron Grey
Hi, good morning and thanks for the question. I guess just the one that I'll have is on the top-line for the quarter, when we look at GAAP revenues. So I know you pointed towards it being Massachusetts and the wholesale opportunities there. I guess was it more a function of the product being able—you having the product to sell? Or was it not the demand. So I guess in terms of like the sequential growth there in terms of the decline? And then how best to think about Massachusetts or the wholesale market going forward given there seems to be the reason you didn't have as much sequential growth? Thank you.

Glen Leibowitz
Sure, Aaron, this is Glen. Thanks for the question. It's more of a timing situation. So, if you focus on the details here as I mentioned Massachusetts, it was a wholesale situation. So those are going to be as the market demand is there. And we know it's a robust market. It was just a timing situation that it didn't occur. But we're very optimistic about what's going on in Q1 already of 2020.

Additionally, there's other wholesale situations. Again these are all timing because as the cycle relates to the harvest taking certain time periods and getting those done and getting those out to end customers. It's just—is really just the timing of sequence of events. So I don't see that softening, just managing the overall process and getting those to market on a timely basis and where the calendar ended is really the situation.

Operator
Our next question today comes from Brett Hundley at Seaport Global.

Brett Hundley
Hi, thank you and good morning guys. I have a bunch of questions. I think maybe one that I would like to ask because I do think that you guys flushed out the margin story pretty well during the quarter. I want to ask a question about your stock relative to Canopy. Ever since that transaction was announced your spread relative to Canopy has continued to deteriorate.

Now you're at about 23%, 24% of CGC. And given that there have been some management changes over there since your transaction was announced, and given that Congress has had such a hard time moving on relatively simple bills like the SAFE Banking Act for example. Can you just revisit with us on the commitment to that transaction and where you see things heading going forward with Canopy?

And if I can tack on there of course, if you can give us a comment on your view of the SAFE Banking Act just given what Crapo [ph] has said I'd really appreciate that as well? Thanks guys.

Kevin Murphy
Sure. It's Kevin Murphy and I—a complex question and I'll answer as best I can. I would say that from

the relationship with Canopy it was a complex transaction, it was very, very new hadn't been done before and it has consistently been misunderstood. We are as disappointed clearly with the spread as everyone else, but I can tell you with certainty the new management at Canopy is 100% dedicated to frankly making our company as important in the US as any other company.

So they are dedicated to complete the transaction and we have a very, very close relationship now with the new management. That said, after doing the transaction mid-last year there was some delay and some disruption with the change of management which we believe delayed us to some degree in rolling out the synergies that we hope to garner from Canopy going forward in 2020 and beyond.

So we are lockstep with them working very closely with them and the new management. And candidly that relationship couldn't be better. Now that said, we believe as we prove more synergies and more completeness of that relationship going forward, that should prove to the rest of the investment community that this has—this transaction, it made a lot of sense.

Now as it relates to Washington and it relates to frankly the quagmire that I had spoken to as is related to SAFE Banking. Senator Crapo is very much opposed to cannabis reform. I think it's that plus the impeachment hearings have delayed things in Washington. No question about it.

But with nearly 80% of all states at the end of this year, having some sort of a program whether it's medical or recreational that coupled with the fact that Senator Crapo's term as the Chair of the Financing Committee expires at the end of this year and Senator Toomey from Pennsylvania is a more compassionate supporter of cannabis legalization.

So we believe going forward there may be some movement on Safe Banking in 2020, given the fact that it's going to be a real discussion point with the presidential election, we remain optimistic. Timing is always tricky, candidly given that other things in Washington pop up, which frankly have—get more attention, but I believe SAFE Banking should be on a very clear path at a minimum post Senator Crapo.

Operator
Our next question today comes from Matt Bottomley at Canaccord Genuity. Please go ahead.

Matt Bottomley
Yes, good morning. Thanks for taking the question. Just wanted to get a little more color, now that you've just secured additional financing. If you can kind of put your balance sheet maybe more on a pro forma basis and line it up to your 2020 objectives that you have. So obviously there's the CAPEX budget you outlined, there's the interim operating losses. Until you reach cash flow positivity by the end of the year hopefully. Just curious if you believe that what's secured now is sufficient to meet all those objectives? And then what other types of opportunistic financings might you be open to down the road?

Glen Leibowitz
Sure. Thanks for the question Matt. This is Glen. Yes, as I mentioned in my prepared comments, CAPEX target for 2020 is approximately $50 million. We'll, obviously, utilize a REIT to the extent we can. And then just high level, we'll need the cash for operations of approximately $65 -- $60 million to $65 million for 2020. So if you take the $50 million and the $65 million, we're looking about $100 million, $110 million, $115 million of capital that's needed. So the capital profile is as I mentioned short-term opportunity that we took advantage of but where we need to secure additional long-term financing and we're actively in those discussions and we're optimistic about closing on additional capital in the very short-term.

Operator

Our next question comes from Graham Kreindler of 8 Capital. Please go ahead.

Graham Kreindler
Hi, good morning, and thanks for taking my question. I just wanted to follow-up and get a better understanding of the operations in Florida. And particularly on the supply side, I believe last conference call you mentioned that you broke ground on a planned 100,000 square foot facility. And given the comments in the prepared remarks about purposely holding back some of the retail openings there. I was just wondering if you could give us an update on how the ongoing construction of this facility is going. And when you're targeting our first harvest? Thank you.

Glen Leibowitz
Sure. And Graham thanks for the question, it's Glen. I'll start and Kevin can give an overview after I speak. So we did break ground on the facility. We are in possession of the demolition permit. So we're going to start work very quickly on the facility itself. But in the meantime we've had pods at the location, which have been germinating the product. So we expect to have significant product to supply the one store that I mentioned.

So the reason we hadn't opened it is we wanted to make sure we have constant supply for our consumer base and creating that customer loyalty, because we know peers of ours have been running out of product and we don't want to be in a similar situation. So the construction timeline will probably be later to complete the overall facility probably the end of 2020.

But in the meantime, we'll have that one store plus I think we could probably supply two more stores. So we'd have a total of three stores at a minimum open to meet our public demand. And then later in the back half of the year have the bigger facility operational to handle additional stores that we plan to build during 2020 with expectation to open in 2021.

Operator
Our next question today comes from Glenn Mattson at Ladenburg Thalmann. Please go ahead.

Glenn Mattson
Hi, thanks for taking the question. One quick clarify, I want to see did you say that same-store sales in the quarter were in line with the year so up 40%? So that would be one thing.

Second of all, I wanted to -- I was curious if -- obviously besides the wholesale decline sequentially in Massachusetts, would you point out any markets that performed particularly better and were particularly worse than the corporate average?

And then last, just quickly if you could -- Glen, kind of give us an idea of when the cost cuts kick in and how they flow through over the course of the year? Thanks.

Glen Leibowitz
Sure. I'll just -- I'll read -- this is Glen. Thanks Glenn for the question. So just to reaffirm on the sequential changes there, so a little bit more color. I mentioned that Form Factory is still ramping. So that would impact the wholesale of Pennsylvania operation, again this is timing. So that had a slight impact so that overall as well as, as you noted the Massachusetts which was about a $2.2 million wholesale sale in Q3.

Bright spots. New York operations had some margin improvement, which offset some of that decline. So that's the color there. I'm just checking some notes here.

Same-store sales were consistent growth of about 40%. What you're seeing is mostly in the medical markets, we're seeing about a 50% growth same-store sales as compared to our—about a 20% change on the adult-use stores. So that blended was about the 40% that we mentioned. And sorry -- the last part of that question on this.

Glenn Mattson
The kick in and how they flow through over the course of the year?

Glen Leibowitz
Sorry, got it. Thank you. So initially the annual savings as we mentioned was approximately $7 million. There'll be a one-time charge of about $900,000 associated with the separations and the staff optimizations. But then we expect that to be on a pro rata basis over the next several quarters for the rest of the year.

So for a full year of 2021, we look to realize those $7 million of savings. So in the current year, it's going to be about $4.5 million, $5 million sales in 2020.

Operator
And the next question today comes from Russell Stanley, Beacon Securities. Please go ahead.

Russell Stanley
Good morning. Just on New Jersey, congrats on getting Atlantic City open. Just wondering what your latest plans are around the third dispensary there? And as a follow-up, the latest view on the timeline for converting that to a for-profit operation and consolidating those numbers?

Glen Leibowitz
Thanks Russell. This is Glen again. So, on the third location, we have it identified in New Jersey. I think we have a permit and as well as the lease. So we just need to get hammers swinging at that location.

So I'd say that's probably normally a three-month to four-month build out process to get that online. We haven't publicly announced that location. But once that's available to us, we will make that announcement.

And then just the overall timeline, we'd expect to have 30 to 45 days expected on the conversion of that not-for-profit to be in our consolidated numbers, but we'll obviously make that announcement once we have regulatory approval and more certainty around it.

Operator
Our next question comes from Rommel Dionisio of Compass Point. Please go ahead.

Rommel Dionisio
Good morning. Thanks for taking my question. On the—Glen, in your comments about the same-store sales being up about 50% in medical markets. Just a little more color on that. Would you say some of that is obviously more medical patients in those particular states signing up, are you taking market share or product mix shift? Maybe just a little color there.

And also just lastly, do you guys see any meaningful vape-related impact in Q4 on overall revenues? Thanks.

Glen Leibowitz
Thanks, Rommel for the question. So just on the medical a little bit more color there. So same-store sales are up about 50%. The transaction growth is the main driver there. So average ticket is about flat

per customer, but it's really the volume and the number of transactions are up significantly on a same-store sale basis. So that's the driver, the drivers there.

CONCLUSION

Operator
Thank you. Ladies and gentlemen, this concludes today's question-and-answer session and today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.