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OrganiGram Holdings, Inc. (OGI.CA)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is a Randson. I'll be your operator today. At this time, I would like to welcome everyone to the OrganiGram Holdings Inc.'s Third Quarter Fiscal 2021 Earnings Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. We ask you to please limit yourself to one question and one follow-up question. You may requeue if you have further questions. As a reminder, this conference call is being recorded and a replay will be available on OrganiGram's website.

At this time, I would like to introduce Ms. Amy Schwalm, Vice President, Investor Relations.

Amy Schwalm
Vice President-Investor Relations, OrganiGram Holdings, Inc.

Thank you Randson. Joining me today are OrganiGram's Chief Financial Officer, Derrick West; and our Chief Strategy Officer, Paolo de Luca. Before we begin, I would like to remind you that today's call will include estimates and other forward-looking information from which our actual results could differ. Please review the cautionary language in today's press release regarding various factors, assumptions and risks that could cause our actual results to differ. Furthermore, during this call, we will refer to certain non-IFRS financial measures, including adjusted EBITDA and adjusted gross margin. These measures do not have any standardized meaning under IFRS and our approach in calculating these measures may differ from that of other issuers and so may not be directly comparable. Please see today's earnings report for more information about these measures.

I will now hand the call over to Paolo.

Paolo de Luca

Chief Strategy Officer, OrganiGram Holdings, Inc.

Thanks Amy. Good morning, and thank you for joining Derrick and me today. We do not have our permanent CEO on place as we are conducting this call, and I will address that right upfront in terms of what we can share with you at this point. That way the questions and answers portion at the end of this call can be focused on other questions that you might have. Speaking on behalf of our board of directors, we know that it is a priority to get the right person in the role as soon as possible. A leading search firm has been hired and committee responsible for the selection of a new CEO has been busy reviewing candidates from across the CPG sector in North America. They are now in the second stage of the interview process with a shortlist of candidates. In any event, the company is operating very well during this interim period with a management team and board working together more closely than ever to expedite decision making.

I would also like to point out that our Chairman Peter Amirault is acting as a Executive Chair and he brings tremendous experience being the longest serving board member of the company as well as deep CPG experience through a series of senior executive roles, including at Molson and Cara Foods. We feel very equipped as a management team with the key input and oversight from Peter and the rest of our board of directors. Many of the senior executives have a strong track record at the company, and have contributed to the success we are seeing from our revitalized product portfolio which I will talk about more in a moment. In addition to some longstanding executives, we also announced two key new hires with deep experience in cannabis and CPG.

Our SVP of Marketing and Communications Megan McCrea, as well as our VP of Innovation, Borna Zlamalik. We also onboarded great confectionary management capabilities as part of our Edibles and Infusions acquisition in James Fletcher who remains President of EIC. In addition to a better top line trend, we have seen cultivation ramp with the benefit of increased stacking and critically we have seen cultivation cost per gram continue to decline on the back of higher plant yield, as well as a realization of other cost efficiencies and improvements. We have our newly promoted Vice President of Operations, Nathalie Batten to thank for leading these efforts. Again, all of this to reinforce that we feel very good about managing the business through this interim period, and continue to benefit from the long track record and expertise of Peter Amirault, and the rest of the board.

We feel even better about our prospects when we look at the strong outlook for the entire industry and with COVID restrictions being unwound nationwide, a strong seasonal backdrop and the ongoing expansion of the retail store network in key markets of Ontario. Derrick will go into more specifics on our outlook for our fiscal Q4. So just to sell-off before I continue to discuss the quarter, we won't be answering any other questions on the CEO search on this call, but look forward to updating you as soon as we are able to. Now, I will move along to the fiscal Q3 results that we released earlier this morning. I will talk a little about revenue and new product launches, as well as some of our strategic developments, and will leave Derrick to go through detailed financials, and our outlook for Q4.

As we expect and directionally guided, and I say directionally as we do not provide specific revenue or earnings guidance. In our last quarter's disclosure Q3 revenue improved from a challenged Q2, which we believe represents a clear inflexion point for the company. As I mentioned, we have ramped up operations and staffing such that we were better able to fulfil demand in Q3. We believe Q3 revenue was negatively impacted by relatively suppressed demand from some provincial boards, particularly in the most populous province of Ontario. Strict COVID-19 restrictions in Ontario meant less staffing to enable physical distance and retail stores be limited to 25% capacity for most of March, and then closed completely to all foot traffic for the balance of our fiscal quarter, which ended May 31, 2021.

However, we did not have the production disruptions related to COVID-19 cases that occurred in our Q2 quarter ending February 28, which essentially shut down the Moncton facility temporarily on two occasions sending larger groups of employees home to isolate. Our revitalized product portfolio is resonating with consumers, and this is reflected in revenue growth in Q3. We conduct ongoing consumer research and leverage detailed analysis of our consumer purchasing behaviours to help ensure our offerings are aligned with existing and expected evolutions and consumer preferences. Consumer trends have continued to emerge and call us, including ongoing growth in the large format value segment, a desire for higher THC, as well as attention for newness including new genetic strains and novel products.

OrganiGram began a product portfolio revitalization in mid calendar 2020 to address these consumer trends and preferences. We have launched 84 new SKUs since July 2020, and up to 20 more SKUs are still to come in Q4 of fiscal 2021. Dried flower and pre-rolls remain the first, and second largest categories respectively in the Canadian adult use recreational market of all product form factors, and the company believes these categories will continue to dominate based on the sales history in mature legal markets concerning US states, as well as regulatory restrictions on other form factors, for example, the 10 milligram per package THC limit in the edibles category. Cannabis consumers continue to want both high THC dried flower products and part of our diversity is supported by available sales data.

In the popular value segment, sales of SHRED continued to impress almost tripling from last quarter and representing the fastest growing brand in the country. It has remained the number one most searched brand on the OCS website for the last eight consecutive months. There are a number of exciting developments I want to highlight when it comes to this highly demanded product. First, the product margin on SHRED is improving with a pivoting commercial strategy and a declining cost structure as our yields and efficiencies are improving with increased scale. Second, we have had the benefit of being able to leverage SHRED's extremely strong brand equity to introduce new better margin products like SHRED, Jar of Joints, a convenient jar of 14.5-gram pre-rolls of SHRED's Tropic Thunder. And we have more to come, so stay tuned. We will obviously provide details as these products are rolled out.

Leading Q3, OrganiGram officially announced the launch of Big Bag o' Buds, indoor-grown, strain specific dried flower in a 28-gram value format. The new Big Bag o' Buds line-up includes existing cultivars such as the company's industry-leading Ultra Sour, otherwise known as Limelight in our Edison brand, along with new cultivars and a rotation of one-time strain offers. Big Bag o' Buds contains a minimum of 17% THC and one-time offer or OTOs will range in strain selections including Grapefruit GG4, Original Glue and Lemon Tree strains. Big Bag o' Buds doubled its sales in Q3 from Q2 and we see this excellent trend continuing into Q4. As we said last quarter, we are focused on growing our sales mix into a higher margin dried flower brands.

We have made ongoing investments in genetics to support the Edison brand promise of innovation in new and exciting products. We plan to keep the Edison brand revitalized over time with new strains as well as high potency. As you have heard other licensed producers lament, it is not easy to grow new strains at scale with both high THC and balancing that with high findings, but we are increasingly encouraged by our progress, and recent results. In Q2 fiscal 2021 the company launched three new Edison cannabis indica strains which included high potency, Black Cherry Punch, and Ice Cream Cake or I.C.C., as well as Slurricane. Black Cherry Punch joins Limelight as the top seller of their respective strains amongst other LPs with similar strains in market.

In late April 2021 the company announced the launch of another two new high potency Edison dried flower strains, GMO Cookies and MAC-1, which had a THC range of 20% to 26% and are available in either a 3.5-gram format or a package of three half-gram pre-rolls. Both strains feature a distinct phenotypic profile, flavour and aroma as a result of being grown in one of OrganiGram's strain specific micro-climates. We expect to introduce more new cultivars under the Edison brand in the near term. In late March the company introduced another high margin dried flower brand in the market called Indi, one of Canada's only cannabis brand dedicated exclusively to indica cultivars. Skyway Kush was the first and only strains in the company's Indi portfolio offering THC in the range of 20% to 23% until June when we launched two new Indi stream in 3.5-gram formats, Biscotti Gelato with a THC range of 20 to 26%, and Gelato #33 with a THC range of 17% to 23%.

Pre-rolls are the second largest category in adult use recreational market, and the fastest growing on a quarterly basis this year at about 33% in calendar Q2 over Q1. In late March of this year we introduced a new Edison strains of Black Cherry Punch, I.C.C. and Slurricane in a package of three half-grams pre-rolls produced with our new pre-roll machine. This machine was commissioned in March and is now producing an average of about 40 pre-rolls per minute. We have ordered another machine expected to be delivered and commissioned in early Q1 fiscal 2022 as pre-roll demand hasn't shown any signs of slowing down.

Derivative product sales were lower in Q3 than Q2, but we look forward to gain sales traction in the largest derivative product category BAT with the launch of two new BAT products with higher THC concentrations. These include an Edison plus feather disposable vape pen at a very competitive price point as well as a new 1-gram Edison cartridge for the size 10 vaporizer. Both products are based on Limelight, our top selling flower stream, and the country's best selling Ultra Sour. And we expect our new soft chews or gummies to be available in certain retail stores in early August. To-date in Canada, edibles are one of the fastest-growing segments of derivative products, and the largest product subcategory within edibles is gummies.

With our acquisition of Winnipeg-based Edibles and Infusions Corporation, or EIC for short, we enter this market backed by leadership with proven confectionary experience and a track record of delivery to some of the world's biggest retailers, including Costco and Walmart. We now have two facilities capable of R&D, product development and large-scale manufacturing capabilities to deliver derivative products: our flagship facility in Moncton, and our derivatives dedicated EIC facility in Winnipeg, both designed and build with EU-GMP specification standards in mind. While flower and related products still account for more than 70% of the overall Canadian market, derivatives sales growth is outpacing the overall market as new product formats are launched and consumer preferences evolve. For example, edibles clearly represent about 4% of the Canadian BAT market compared to 12% to 15% in more mature US markets.

Lastly, we have a very innovative derivative product launch still to come in Q4 fiscal 2021. I do not want to give away any more details until we are ready to launch except to say our team is very excited about the potential of this product.

In addition to the acquisition of EIC, we also announced a collaboration with and strategic investment from BAT in March. I won't reiterate all of the details of the transaction as we covered it in great detail last quarter. However, by way of update, we were pleased to announce the successful launch of the Center of Excellence, or CoE, at our Moncton facility as outlined in the PDC agreement with BAT. The CoE has been established to focus on developing the next generation of cannabis products with initial focus on CBD.

As the company and BAT refine plans and ramp up on execution for the CoE, a number of initial skilled positions have been created, including innovation-focused roles, such as scientists and product developers, and over time the employee count is expected to increase as new projects and work streams are brought on line.

The CoE is governed and supervised by a steering committee consisting of an equal number of senior members of each of OrganiGram and BAT. Under the terms of the PDC Agreement, both OrganiGram and BAT have access to certain of each other's intellectual property and, subject to certain limitations, have the right to independently and globally commercialize the products, technologies and IT created pursuant to the PDC Agreement.

Approximately CAD 31 million of BAT's CAD 221 million investment in OrganiGram has been reserved for OrganiGram's portion of its funding obligations under the initially mutually agreed upon three-year budget. Costs relating to the CoE are being funded equally by OrganiGram and BAT.

From a governance perspective, there is a steering committee supervising governed CoE activities with the equal number of senior members from both companies. And we also anticipate benefiting from two BAT nominees to OrganiGram's board of directors. At closing of the transaction, we welcome Mr. Jeyan Heper to our board and the other nominee is expected to be appointed in the near-term.

Not only is this collaboration with BAT going to accelerate and strengthen our research and product development activities, it is also anticipated to be instrumental in establishing the foundation for our US and international strategies. As part of the transaction, BAT invested approximately CAD 221 million in us or 19.9% equity interest. With the significant capital injection, OrganiGram is well-positioned to expand into the US and other international markets at the right time and subject to applicable law.

I will now turn the call over to CFO, Derrick West.

Derrick W. West

Chief Financial Officer, OrganiGram Holdings, Inc.

Thanks, Paolo. I will start with our strong financial position. As we announced last quarter, we have a balance sheet free of any significant debt after repaying our entire term loan balance of CAD 58.5 million. This elimination of our debt amounts to about CAD 2.7 million in annual interest savings.

In terms of liquidity, including CAD 31 million in restricted funds, the company currently has CAD 220 million in cash and short-term investments. We have made the decision to complete the Phase 4C expansion of our Moncton facility for more production capacity in order to meet the longer-term forecasted demand for our products. We are also making changes to our growing and harvesting methodologies as well as design improvements to the Moncton campus that are expected to result in higher-quality flower and reduced production cost.

The budgeted amount for Phase 4C and this work is estimated to be CAD 38 million and anticipated to be incurred starting in fiscal Q4 2021 with completion targeted during fiscal 2023. We have sufficient cash and short-term investments to support these expenditures and the corresponding growth to our working capital assets, while still maintaining sufficient liquidity and financial flexibility. As you may have noted, we did file a preliminary base shelf perspective just recently, which allows us to move quickly to access even more capital to pursue attractive growth opportunities should they arise.

Q3 2021 net cash used in operating activities of CAD 10.8 million compared to CAD 2.3 million provided by operating activities in the same prior-year period. The change was largely due to the increase in working capital assets as the company ramped up cultivation activities during the current quarter.

Turning to our earnings results for Q3. Gross revenue grew 51% from Q2 2021 and 31% from the same period in fiscal 2020 to CAD 29.1 million, and net revenue grew 39% from Q2 and 13% from same prior-year period, respectively, to CAD 20.3 million. The revenue growth was primarily due to higher adult use net revenue which grew 40% from Q2 and 10% from the same period in 2020, and higher wholesale revenue which our sales to other licensed producers during Q3 of this year. Cost of sales decreased 47% to CAD 23.4 million from Q3 of 2020 primarily due to almost CAD 30 million in inventory write-offs reported in Q3 of last year, and provisions as well as charges related to a reduced workforce due to COVID-19 which were all incurred in the prior-year period.

The charge related to unabsorbed fixed overhead and included in cost of sales continues to decline again sequentially this quarter as we expected and indicated in our Q2 2021 disclosures. It is anticipated to decline further in Q4 as we continue to ramp operations. We harvested 8,379 kilos of flowers during Q3 compared to 4,741 kilos of flower in Q3 of the prior year. The increase from a comparative period was primarily related to increased cultivation, planting and staffing in Q3 of this year to increased demand for many of the new products as part of the product portfolio revitalization, as well as the increasing industry demand on the back of the ongoing accelerated retail store buildout particularly in Ontario.

We were using approximately 80% of our grow rooms in Q3 fiscal 2021, and as of the date of our MD&A we were using 85% of our grow rooms. Once complete Phase 4C increased our annual capacity for the production of flower from 38,000 kilos to approximately 65,000 kilos. The total capacity of the company's Moncton campus facility will continue to fluctuate as the company further refines its growing methods and growing utilization. IFRS gross margin increased to a positive CAD 2.1 million from the negative CAD 15 million in Q3 of 2020 largely due to lower cost of sales as I just described as what was net non-cash positive fair value changes to biological assets in inventory so in Q3 of 2021 versus negative changes in the prior year comparison period.

Adjusted gross margin was a negative CAD 0.7 million in Q3 2021 as compared to a positive CAD 4.1 million in the same prior-year period largely as a result of the value segment offers comprising a larger proportion of total revenues in Q3 of 2021 combined with prior period higher cultivation cost making up the current period's cost of sales. SG&A, excluding non-cash share based compensation increased to CAD 13.6 million from CAD 10.3 million in Q3 of 2020 largely due to increased staffing and office cost related to the establishment of the OrganiGram BAT Center of Excellence and EIC acquisition, higher cultivation related research and development cost, as well as higher audit fees in connection with the company's regulatory requirement to obtain an integrated [indiscernible] (22:14) for the first time for fiscal 2021 financial statement.

Adjusted EBITDA increased to a negative CAD 10.2 million from a negative CAD 2.1 million in Q3 2020 largely due to lower adjusted gross margins in Q3 2021 and due to some higher general and administrative cost as I just described. And net loss in Q3 of 2021 was reduced from Q3 2020 loss of CAD 90 million to CAD 4 million. The improvement to earnings was as a result of higher IFRS gross margin during the current quarter combined with the impairment charge to the property, plant and equipment reported in the prior-year period. I will wrap up with our outlook for our Q4 fiscal 2021. Just a reminder, we won't be reporting on this Q4 quarter until later in November in accordance with the filing deadlines for financial year-ends.

First, we are very positive on the outlook for industry growth. According to Hifyre data, Canada wide recreational retail sales are expected to total CAD 309 million in June which is a slight decline from the Hifyre estimated revenue of CAD 322 million in May and positive CAD 310 million in April which is the most recent available data from Statistics Canada (sic) [Stats Canada] (23:33). Based on the estimates available from Hifyre, the second quarter of calendar 2021 was a record for the Canadian cannabis market with CAD 940 million in total rec retail sales and implies sequential quarterly growth of 12%. This occurred despite the strict COVID-19 restrictions in place.

There are a few factors creating tailwinds for further industry growth, first, the legalization October of 2019 of many derivative product categories has attracted consumers who are not interested in smoking or vaporizing dried flower including pre-rolls. New categories such as vape pens, edibles, which is the soft chews and chocolates, beverages and other congestible products have significantly expanded the addressable market. Second, retail stores continued to open with Ontario driving the growth and driving 1,000 stores opening in the province by the end of summer. Since July, the store count in the provinces grew by 131% to 2,221 stores currently driven by Ontario growing 755% to 872 stores. And of course, these stores in many provinces have been closed to foot traffic for much of 2021 and remnant to delivering in some cases [indiscernible] (24:52).

We know that the cannabis consumers want to be able to go into stores to buy their product. As such we should see a boost in sales as these stores have recently been permitted to reopen to foot traffic. Some of the new stores authorized opening for the first time ever. Third, the industry as a whole has made a constant considerate effort to convert consumers from illicit to legal consumption. The gap between Canada's legal and illicit cannabis market continues to widen the latest assist to Canada data suggests. Household spending on adult use cannabis products and regular channels grew to CAD 918 million in the final quarter of 2020 or CAD 204 million more than the estimated amount spent on illicit cannabis in the same period.

Spending on legal recreational cannabis overtook illegal transactions for first time in the third quarter of 2020 when regulated expenditures outpaced approximate illicit sales by only CAD 59 million. The legal market benefited from the growing retail options in calendar 2020, regulated sales also benefited from a larger breadth of consistent inventory and improved selection of products. In February of 2021 the province of British Columbia tested illicit cube cannabis and found 24 distinct pesticides and 20 samples of dried flower. The samples went to a federally licensed lab for testing and results show that a lot of the 24 unapproved pesticides, there were high levels of bacteria, fungi and heavy metals in many of the samples. These samples were subjected to the same full panel analysis to detect chemical and micro-bio containments as licensed cannabis producers are required to use.

We believe the more that knowledge like this becomes better known amongst consumers, the more illicit cannabis consumers shift to the legal market. In this backdrop of strong industry growth, particularly as COVID-19 restrictions are being removed nationwide in a strong seasonal period, we expect to generate higher sequential revenue in Q4 fiscal 2021 as compared to Q3. We have strong demand for our revitalized product portfolio and the increased cultivation and more staffing we are better equipped to fulfill that demand. Revenues to-date and purchase order from customers support our expectation for higher revenue in Q4. Beyond Q4, we expect to resume shipments to Canndoc in Israel in Q1 of fiscal 2022. We received a Good Agricultural Practice certification by the Control Union Medical Cannabis Standard to comply with Israel's updated standards for importing cannabis in early Q4.

However, the timing of shipments is contingent upon regulatory approval from Health Canada including obtaining an export permit. We also expect to see a sequential improvement in adjusted gross margins in Q4 fiscal 2021 largely due to lower product cultivation costs as well as other economies of scale as we continue to ramp-up cultivation and realize the benefit of ongoing cost efficiency improvements. The overall level of Q4 fiscal 2021 adjusted gross margins versus Q3 will also be dependent on other factors including but not limited to product category and brand sales mix. Although, the sequential improvement to adjusted gross margins is anticipated to be fairly marginal in Q4 fiscal 2021, the company has identified a number of opportunities which it believes has the potential to further improve adjusted gross margins over time.

We expect to gain economies of scale and efficiencies as we continue to scale up cultivation. As I noted earlier, we plan to make changes to our growing and harvesting methodologies that should not only enhance the quality of our flower but also reduce production cost over time. The recent launches in newer higher margin dried flowers strains under Edison and Indi brands with more expected to come have the potential to positively impact gross margin as these products gain traction in the market and comprise a greater proportion of the company's overall revenue. International sales have historically attracted higher margins and are expected to represent a greater proportion of revenue once we resume shipments to Canndoc.

Further, we continue to launch more multi-pack pre-rolls and 1 gram vape cartridges and these higher volumes SKUs generally attract higher margins. The company continues to invest in automation to drive cost efficiencies and reduce dependence on manual labor. Lastly, Q4 fiscal 2021 SG&A is expected to be higher than Q3 primarily due to the R&D work at the Center of Excellence and increased selling and marketing expenses as stores reopen to foot traffic and the retail network expands. In closing, we feel very confident about our prospects and remain focused on operational execution to drive top-line growth, and just as importantly to drive cost reduction and operational efficiencies. At the same time, we are investing in innovation and research and product development which we believe is critical to gain and sustain a long-term competitive advantage in the industry.

So that concludes our prepared remarks. Operator, if you could go ahead and open up the line for questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. We have our first question from the line of David Kideckel from ATB Capital Markets. Your line is now open.

David M. Kideckel
Analyst, ATB Capital Markets, Inc.

Q

Hi. Good morning. Congratulations on the quarter. Thanks for taking my questions here. I want to start picking your prepared remarks. You mentioned revenue mix, and you look at margins been increased in Q4 as a result of product category or dependent upon product category and sales mix. I just wanted to know from OrganiGram's perspective, now with dispensaries opening, many of the COVID restrictions lifting, to what extent do you view this as a tailwind for you and the industry as a whole, especially when it comes to the derivative products or 2.0 product offerings, just given that we know that many consumers acquire that in-store or dispensary in basic experience to actually educate a lot of their decisions with these products? And with that said, are you able to comment at all about what you potentially think that a revenue mix could look like from a 1.0 versus 2.0 product category split? Thanks.

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Hey, David. Can you hear me okay?

David M. Kideckel
Analyst, ATB Capital Markets, Inc.

Q

Yeah, loud and clear.

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Perfect. Thanks for the question. It's a great question. First of all, yes, we do view everything that's happening in terms of the stores, the availability of both new stores opening and also in-store foot traffic and also just the seasonality where we are in kind of the summer, the kind of the whole social experience and so forth, we do view that as a tailwind.

I think your point on derivative products is bang on. Some of those products require a bit more hand holding maybe from budtenders. I was in a store in Toronto just last week, walked in and I was really taken aback about how much a budtender could influence a consumer's purchase decision. The person in question walks into the store, kind of middle-age man, and the budtender really had a strong influence in terms of – in this particular instance, he was looking to buy an edible and really helped him navigate to a particular brand and so forth.

So when I think of derivative products, when I think our derivative products in particular, our Powdered Beverage, which I think is a relatively novel and innovative product, that will certainly do better in our view in a situation where someone walks into the store and can be navigated by a budtender to a different type of beverage maybe something that's not as heavy to carry around, something that they could put in their purse or their back pocket now that they're able to be more social under better kind of COVID environment. We think the same things really with our gummies which are going to be coming out in August, and I think chocolate is also another great opportunity which is dearer to the kind of fall and winter seasons.

So, I definitely think that derivatives will be a big beneficiary of in-person store traffic and the expansion of retail stores. Our derivative portfolio in aggregate, has probably under-indexed the Canadian market in the last year. That is also by design in our part, because with the restrictions of COVID and the limitations that we experienced there for a while in terms of less staffing we thought it was prudent and pivots to higher, bigger categories such as flower and pre-roll. So we've over indexed there even against the 70% which I said in the prepared comments. But I think we'll definitely be shifting more to derivatives going forward, and starting with Q4 as well you'll see some product launches in the next month to two months that we're excited about. And yeah, Derrick do you want to add anything on the margins or the revenue mix?

Derrick W. West
Chief Financial Officer, OrganiGram Holdings, Inc.
A

Yeah. I would say that as it relates to [indiscernible] (34:43), we don't disclose any exact margins for any product categories and brands, but I would say that it's a mix on all of it in terms of point to any product category. There is various margins to any new formats and the brand. I would say that we will benefit over time with the economies of scale that we expect to get as we're lowering the cost per unit, cost per gram, which positively impacts all of our product categories including derivatives, although not as direct in one-to-one as well with the flower categories. And so we will essentially double the production volume in Q3 compared to Q1, and where a big large portion of our cost are fixed we are benefiting significantly over the last quarter with regards to lower cost per gram, and we'll start to see that show up, most of that benefit ends up into our inventory and it's got sold and we'll start to see that as we look forward to a certain extent and as we continue to move to higher production levels, while there will be a bit out of timing and it's not always going to be exact, but definitely with the higher production levels we're running at along other efficiencies and operational improvements that we're making and getting improved yields [indiscernible] (36:07) there is positive, this positive brings us back now as it leads to our cost per gram and that will help margins as we look forward for other categories.

David M. Kideckel
Analyst, ATB Capital Markets, Inc.
Q

Okay. Thanks Paolo and Derrick. Very helpful. Last question from me and then I'll hop back in the queue. I just, I know you mentioned in your prepared remarks the Center of Excellence associated with the British American Tobacco company. Beyond what you've said in your prepared remarks, is there any color you can give us, or what type of products you expect to hit the market and potential timing here, for example, are these going to be existing products that you already have that you're looking to tweak, the chocolates or beverages, or are these going to be a new product offerings altogether? Thank you and congrats on the quarter again.

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Thanks David. Yeah, look, on the BAT, there's not a ton that we can really say because we just launched it. I can tell you that we're extremely happy with the people that are involved in the CoE, the hirings that we've made, the launch has gone very well to date, and the teams within that group are working on product lines and work plans and so forth. I think the best thing to do in terms of to kind of talk about where this is heading is, for sure the products will be in derivative type of style products. The focus really is on product innovation and also research, understanding safety, understanding the efficacy of the products, and that will be the foundation to which these derivative products will be developed.

So the idea here is to really develop IT and product, products that can transcend borders, that is when so once we have developed them and we have IT supporting them and we've got a body of research and testing to support how these products work that we can establish them as products in markets around the world, subject to regulations. And we think that the work that we're going to do is going to be a part of regardless of which market you go into, regulators and public health officials are going to be first and foremost concerned about safety, and again efficacy and the ability to make product claims is going to be based off of that. So derivative products, safety and efficacy supported by research, supported by science and with the focus in terms of cannabinoids primarily on CBD.

In terms of timing, I think we should be very realistic about specifications. There is certainly nothing that we're expecting to bring to market in the next kind of 12 months. Beyond that it will be subject to which product and how far we are along in progress. And in terms of whether there will be innovations on existing products that we have at or completely new products, the answer to that is both. Again, subject to the work streams and the product lines that our teams put together, which we're still in the relatively early stages in that. But really excited, I think the people on both sides have been collaborating great. And I think that's just going to get a lot better when we're able to kind of travel more freely and so forth, and I think with COVD kind of hopefully on the down slope, these collaborations will just be amplified going forward and we're excited about everything we've done to-date.

David M. Kideckel
Analyst, ATB Capital Markets, Inc.

Q

Thanks very much. Congrats on the quarter. I'll pass it on.

Operator: Thank you. The next one is from Andrew from Stifel GMP. Please go ahead.

Andrew Partheniou
Analyst, Stifel GMP

Q

Hi good morning. Thank you for taking my questions. Maybe if you could just discus profitability a little bit. You had a big revenue bump this quarter sequentially. But it seems like on a reported adjusted gross margin basis it was relatively stable. Cognizant to that you still have some unabsorbed fixed costs in that and you are continuing to scale. So if your product mix remains stable, could you give us a sense of what kind of revenue level we would need to see in order for you to return to kind of pre-COVID gross margin levels or normalized gross margin?

Derrick W. West
Chief Financial Officer, OrganiGram Holdings, Inc.

A

Yeah. I'm not sure I'm going to do a projection look forward on a breakeven now since on the margin just because we are offering now a large number of product categories, different brands, and there's always [indiscernible] (40:59) in the market. Every quarter we have a number of launches that are coming up and that's happened every quarter, and that does change I guess the mix in terms of the product and there has been pricing compression in the market. We do feel that most of that has been flow through. I would say that the cost reductions on flower over the last two quarters have been significant, most of it does show up in the inventory balances, some of which did help the current period's cost of sales, but not to the extent that we could see on an ongoing basis.

But there was a larger volume of sales in the current quarter with value format that did continue to the increase to the revenue in this period. And so the margin did not move up as much as we would have otherwise targeted, but we would think that with the continued efficiencies from both changes in processes that our VP of Operations as well as facility along with just the natural gains that we're going to achieve through spreading of the cost of the overhead facility, and the removal of the drag for this unabsorbed fixed charge that you are referring to which had increased CAD 1.7 million in the quarter. So I think the combination of all those will lead to – if the volume is the same and the mix is the same, we are going to have mathematically a better margin just because we'd be flowing through a lower comps number. That would just be the mathematical outcome.

But we're targeting revenue growth to continue, and over time we do believe that we will achieve higher margins, but it's just not something that is automatic and happens just in one quarter, but we would expect to see improved margins from product categories, again build lower cost and we just have fair number of initiatives at play and we are achieving much better – it's not just a matter of applying a cost to more production volumes. We're getting better yields out of the room through various process changes that have been implemented. And so we will start to see the benefit of that as we move forward, and of course determine the sales fulfilment and having the higher sales dollars will help as well on the margin and it does have our attention, and we're having continuous meetings on and on, how we can best improve our profitability metrics, but it does start with our margin no question.

Andrew Partheniou
Analyst, Stifel GMP

Q

Okay. Thank you for that color. And maybe just switching gears, Health Canada is expected to start the review of regulations this fall. Just curious if you have any thoughts around that, more specifically perhaps on CBD and how that plays into the BAT partnerships?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Yeah, I can take that question. Look, we're awaiting that review period as well. We have a view that longer term we think CBD will hopefully be available beyond just traditional retail stores. But I think we don't have any inside knowledge on that and can't really offer a firm opinion one way or the other. But just we think over time that will likely happen. I think the CBD market obviously is a market that has a lot of opportunity just based on what we've seen in other jurisdictions as well. And the only thing it can offer as it relates to BAT is that we've signalled some formal communication that is the cannabinoid CBD [indiscernible] (44:52) which will represent a primary focus to start with. So we think that's obviously a bigger addressable market than [indiscernible] (45:01) products. So we will obviously make that a priority, both organic [indiscernible] (45:09).

Andrew Partheniou
Analyst, Stifel GMP

Q

Okay. Thank you.

Derrick W. West
Chief Financial Officer, OrganiGram Holdings, Inc.

A

Okay. I was just going to add to that, that we expect the three-year review to result in some incremental changes to regulation, and some of which may be positive to [indiscernible] (45:23) but we are focused on competing in the playing field that exist now. And we don't predicate our success on the prospect of a favorable regulatory change, but obviously there'll be a certain level of change, then we'll be ready and agile to make a move to take advantage of those changes.

Andrew Partheniou
Analyst, Stifel GMP

Q

Okay. Do you have any view on what changes might occur?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

No, we do not comment on that.

Andrew Partheniou
Analyst, Stifel GMP

Q

Okay. Thank you for taking my question.

Operator: Thank you. The next question is from the line of Tamy Chen. Your line is open.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

Q

Thanks, good morning. First question I had is on the thinking behind the decision to complete the Phase 4 expansion, I noticed another one of your competitors recently brought on a lot of new capacity on there. And so I just wanted to dig into that a bit further. You talked about wanting to meet longer term forecasted demand. But as far as we can see, at least in the earlier part of this year, provinces were still rationalizing SKUs, looks like there have been some share losses among the bigger LPs apparently to some craft growers. So I just wanted to understand what specifically are you seeing that prompted your decision to finish Phase 4, is it discussions with provinces going forward, or is it that you are just getting more bullish on more Ontario stores? Just wanted to dig into that a bit more. Thank you.

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Hey, Tamy, it's Paolo. Great question, and I have a few comments to make on that. So, number one, I think we're bullish on stores, we're bullish on growth. We're also bullish on OrganiGram. We have all the publicly available information [indiscernible] (47:19) point to our market share is increasing, and we're not able to even produce what we need to meet the demand now, so that's part of the decision. Our specific situation at OrganiGram requires us to produce more flowers. We also have as part of the investment initiatives to improve our THC and improve our efficiency. So when we did the analysis, all the signs pointed to that this was the right decision to make and that we needed to do this to grow our business.

In the context of the macro environment, I would just also mention that when you look at the way the industry has unfolded in the past few years, it never made sense for all of the facilities, all the production facilities that were built to be put on line, and we knew that over time the best facilities, what I am to best, I am talking about either lowest cost of cultivation or highest quality product or a combination thereof which survive over the long-term. And we've seen some of the larger players better some of their production facility, because it's either inefficient or cannot produce the right quality flower. And also in M&A situations we've seen companies post M&A again shut the facilities. So what's happened now is the best producers in terms of being able to produce at a lower cost or higher THC or combination there, and we think we are certainly in that category, are going to survive and are going to be the once responsible providing the cultivation in Canada.

So we think that we're needed as a cultivator in Canada, and we needed just for even our own demand, and we are very bullish on Canada as a whole. I think the market is still has a lot of room to grow where we hope to see the growth now that [indiscernible] (49:22) and stores are opened for foot traffic, and we now look at markets like more mature markets in the US like Colorado which has less than 6 million people. They did CAD 2.2 billion in sales in 2020. So if you were to – if Canada falls at trajectory that's even a fraction of that we're going to meet that cultivation. So again, for us this demand on the table that we need to satisfy, there's efficiencies that we need to go after and there is THC improvements that we still we can make, and that's what's driving the decision to make that investment and to finish 4C.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

Q

Got it. Okay. That's very helpful. That was it from me. Thank you.

Operator: Thank you. The next question is from the line of Adam Buckham from Scotiabank. Your line is open.

Adam Buckham
Analyst, Scotiabank

Q

Good morning. Thanks for taking my questions. So maybe a question on the back of Tamy there. You see, talked about your capacity and how it's growing throughout the last two quarters. Are you able to give us an idea what your fill rate is on POs as of Q3 versus your prior quarters?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

I don't know Derrick if you have those numbers handy. I don't have the exact numbers, but I can tell you directly speaking that it's going a lot better, and in particular with a largest province Ontario, we have, I think most recently we filled I think something like 99% of our fills that were actually on some of our bigger SKUs. So a lot of credit to be given to our operations department and not only in any particular did got in a lot better at fulfilling POs, and I think our sales operations planning process has gotten way better, we're really dialling that in, and I think that's going to help us on our efficiencies and also not missing on sales opportunity. So I can't give you exact numbers for the whole company at this point. But I can tell you it has gotten significantly better. We are very pleased, and I think that gives a lot of confidence going forward in terms of meeting our purchase order obligations.

Adam Buckham
Analyst, Scotiabank

Q

Okay. Great. Thanks. So second question from me, I was wondering if we could get an idea. You got some pretty strong sales growth in the flower category. How much of that velocity from a SKU perspective came from larger format versus smaller format products? And I guess secondly like how much of that, you can give us an idea for the newest strains versus some of the more I guess legacy products?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Yeah. I could tell you that we've been rationalized in SKUs to make sure that we're focusing on higher velocity SKUs, and right now we're firing on all cylinders. Our three big brands that I think are worth mentioning SHRED, Edison and Big Bag o' Buds, they're all moving well. Big Bag o' Buds is obviously a large format SKU. SHRED is also, our Jar of Joints is doing extremely well. So we're very pleased with our velocity on the flower and pre-rolls in particular. There's probably a bit more work to do in the derivative portfolio, but that's going to be revitalized in the next month or two and you'll see that with new SKUs coming to market. So we're really excited. I think the biggest kind of limitation we've had is just the availability of flower, which again speaks to our commitment to doubling down, or not doubling but increase in our capacity and finishing off Phase 4C which is already substantially complete.

Adam Buckham
Analyst, Scotiabank

Q

Okay. Great. Thanks.

Operator: Thank you. The next question is from the line of Rupesh Parikh from Oppenheimer. Please go ahead.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my questions. So Paolo, I just had a question just on competitive backdrop out there. So clearly we've seen a lot of consolidation of space really the past few months. So just curious how you feel about OrganiGram's position just given some of the developments out there, and then where does consolidation or M&A, where is the other focus going forward for OrganiGram?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Yeah. Look, I think when you look at the decision tree between buying market share and being extremely dilutive doing that, which I think has been a trend that's some of our peers have demonstrated in the past versus taking that market share with our own internal capabilities, and like we announced today in terms of our commitment to finishing Phase 4C and some processes improvements, the math definitely works in terms of building yourself and expand. And we have the confidence to do that now because our forecasting and our planning and our brands, just our Edison brand and our SHRED brand are so strong. There's so much of brand equity there that we have the confidence to do that ourselves. So I think we're not going to say no to M&A, we've had, we've looked at a lot of companies, none of them have made sense from a risk-reward perspective.

I think we're going to do something in the M&A space. It's going to be much more targeted to either a product category or segment that made you we need a little boost in or to just go a little faster on. But I think, like we're really excited about the market share we've captured the last couple of months, and we think there is actually quite a bit of runway on that as well. So our focus really is on what's in our control which is our two facilities now, one in Moncton and one in Winnipeg, and we still have a lot of optimization to do there. And we think, like I said, answering Tamy's question, our facilities are going to be one of the winners that survives in Canada. It's a crown jewel of ours and I think that's something that others don't have, and we're going to leverage that as much as possible before trying to buy market share with just with M&A, because I think that's not a winning proposition for our shareholders.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. Thank you. I'll pass it along.

Operator: Thank you. We have our last question from the line of John Zamparo from CIBC. Please go ahead.

John Zamparo
Analyst, CIBC World Markets, Inc.

Q

Thank you. Good morning. I'd like to better understand the strategy when it comes to how OrganiGram gets to improve margins, and I ask that with the backdrop of we've all seen the numbers on SHRED. I think we can all agree it's pretty remarkable growth, but it's one of the largest or top-selling brands in Canada already, but that doesn't necessarily result in positive margin. So I wonder, if this need to get to an even higher level of sales to become a positive margin contributor or should we think about it as that is probably not going to be the primary driver of margin expansion and that margin expansion will come from the other categories that you're focused on?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

John, that's a great question. Look, I think, to answer that question what I would say is, SHRED will benefit from increased volume for sure. SHRED will also benefit from lower cost of cultivation which we're already demonstrating. SHRED will also benefit from the line expansions. A Jar of Joints is a good example of that, that's a better margin product example for us than the 7-gram pouches, and we think we can take the brand extension to other provinces as well. The brand equity that SHRED has is remarkable, I mean it's a pleasant surprise for us, and along with Edison I think we've got two real winners to build upon and we're getting brand equity, and cannabis has been a hard proposition for a bunch of reasons, including regulatory and so forth so like can't advertise and all that other stuff.

So I would say, look we want to aim to obviously shift as much as possible to higher margin brands. That is happening already I think with our new Edison strains, and I think that investment that we've made in our facility to bring the THC up will allow us to do that. But we're keeping a close eye on SHRED, and trust me, it's a big topic of discussion internally, and we have a plan to take it to a better margin place and we'll just be patient and watch us roll that out in the next couple of quarters. But I think line expansions would be one answer, efficiencies on just cost of cultivation and then just general efficiencies in terms of the way we operate, I think we're going to get there very soon.

John Zamparo
Analyst, CIBC World Markets, Inc.

Q

Okay. That's very helpful. Thank you. And then second question, as far as it's two parts they are both related to margin though. First, are there other international markets that you're potentially going to selling to over the next couple of quarters? And then second in Canada, how would you characterize where you're at in terms of price compression on the producer side? Is there still a room for this to fall forward in the next few quarters?

Paolo de Luca
Chief Strategy Officer, OrganiGram Holdings, Inc.

A

Yeah. On international I think we're signaling that we're probably going to restart international sales in our fiscal Q1 of next year. International, while we would like to make it a bigger part of our business, we still have a lot of opportunities to deal with in Canada here and we want to make sure that we're capturing all that demand. But longer term I think it's part of our strategy, we do have to figure out a way to get more international sales, and hopefully we'll have more news on that again by the time the next quarter rolls around.

On price compression, look, that's a hard one to answer because that requires a forecast of supply and demand. It's hard to actually get good transparency on what the other producers are producing in terms of KGs, and again I think I made the comment earlier on the M&A question is, we think that there is going to be continued rationalization of cultivation facilities. Obviously as that cultivation comes off line that will -the supply will hopefully start to [indiscernible] (59:54), the equation will start to balance a bit better. On the demand side through we're seeing growth – certainly the proliferation of stores in Ontario is going to drive a lot of that. And so it's certainly a slow down if nothing else, so that's probably a sign that it's bottoming. And I think the margins just become impossible on a certain point for LPs as they keep dropping, so I think rationality will prevail.

And the one thing I'm encouraged with M&A is that, people will be a bit more rational, as I think some of the companies who have done that. However, again I have to look really closely in the mirror to see an essence of the question, is it worth producing in this facility that can't get the THC to the right level or cost of production is too high, that will get rationalized and I think that's going to help the overall supply-demand equation. But on our side we're committed to making money at these prices because we have to within our control to get more efficient and that's what we're driving to. And again, on the THC side we've seen our THC client. But there is still more work to do there, and I think that's the way we're going to do it on our end, just making sure that we maximize our THC and keep our cost as low as possible.

John Zamparo
Analyst, CIBC World Markets, Inc.

Q

Understood. Thank you very much.

Operator: Thank you. This concludes today's conference call. Thank you for participating. You may now disconnect. Have a great day.