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OrganiGram Holdings, Inc. (OGI.CA)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Good morning. My name is Jack and I'll be your conference operator today. At this time I would like to welcome everyone to Organigram Holdings, Inc.'s Third Quarter 2019 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. As a reminder, this conference call is being recorded and a replay will be available on Organigram's website.

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

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

Thank you, operator. Joining me today are Organigram's Chief Executive Officer, Greg Engel; and Chief Financial Officer, Paolo de Luca. Before we begin, I'd like to remind you that today's call include estimates and other forward-looking information from which our actual results could differ. Please review the cautionary language in today's earnings report regarding various factors, assumptions, and risks that could cause our actual results to differ. Further, during this call we will refer to certain non-IFRS financial measures. These measures do not have any standardized meaning under IFRS and our approach in calculating these measures may differ from that of our other issuers, and so these measures may not be exactly comparable. Please see today's earnings report for more information about these measures.

I will now hand the call over to Greg.

Gregory Engel

Chief Executive Officer and Director, OrganiGram Holdings, Inc.

Thanks, Amy. Good morning and thank you for joining today's call. This morning we reported results for our third quarter ended May 31, 2019. I will begin with some comments on Q3 as well as some macro views on the space and a discussion on our outlook and why we're extremely excited about Organigram's prospects and those of the industry. Paolo will discuss the results in more detail as well as our balance sheet strength. Then the operator will open up the call for your questions.

In Q3 we delivered another quarter of strong sales and, just as importantly, we delivered positive adjusted EBITDA for the fourth quarter in a row. With our strong top line and market share translating to positive adjusted EBITDA, we believe we have continued to differentiate ourselves from our peers. Our focus remains on building a sustainable business that generates attractive return on investment for shareholders in the short-term as well as the long-term.

We made progress on a number of other fronts worth highlighting on slide 3. We are now selling our products coast-to-coast as one of only four Canadian LPs with distribution in all 10 provinces. Our Phase 4 expansion is coming along very well and the last phase of Phase 4, which is 4C, is expected to be completed in December. We received Health Canada approval for all Phase 4A grow rooms which currently puts us at 61,000 kilograms per year of licensed capacity, almost double the licensed capacity we had last quarter. We anticipate harvesting from the first grow rooms in Phase 4A before the end of July. We have also already submitted the initial 17 of our 33 Phase 4B rooms in June. Phase 4B in total will add approximately 20,000 kilograms per year, and the remaining 16 4B rooms are expected to be submitted for licensing in September. With Phase 4C – 24,000 kilograms per year – we are targeting total production capacity of 113,000 kilograms per year.

Our Phase 5 refurbishment for an edibles and derivatives facility as well as additional extraction capacity is on track. The entire team is excited about the next growth opportunity coming from the edibles and derivatives market. We have the expertise and we have been derisking our strategy by securing strategic partnerships, increasing capacity, and planning for automation to deliver innovative products which we expect to be ready and in the market when the regulations allow. We also strengthened our balance sheet with a traditional debt financing at attractive rates. And while it seems like old news now, but it is a true milestone, we started trading on the NASDAQ Global Select Exchange on May 21. This exchange obviously offers more exposure to U.S. and global investors, increased liquidity, and puts us on a level playing field with our larger peers.

Turning to the quarter. We grew sales significantly in many of the provinces, particularly in Alberta and each of the Atlantic provinces. Ontario has the highest population of all the provinces, representing approximately 37% of the Canadian population and is currently underserved by retail stores. We have seen recreational cannabis sales highly correlated to the presence of physical retail stores based on a comparison of the provinces in Canada. The Canadian market is positioned to grow significantly with more retail stores opening particularly in the two most populous provinces of Ontario and Québec. Towards the end of the quarter we began to fill a large supply gap with our first shipments of pure CBD oil to markets across Canada. There is a significant unmet consumer demand for CBD products and we attribute our ability to respond to this demand in part [ph] through (00:04:59) strategic arrangements with both 1812 Hemp and Valens GroWorks.

Our medical business is very important to us and we will remain committed to ensuring there is a consistent product supply for our patients. From a medical sales standpoint, Q3 continues to be a strong one for Organigram as our revenue increased and our patient count was up approximately 14% from last quarter. Increased Q3 cultivation costs and lower adjusted gross margin reflected a temporary decrease in yield, as previously disclosed in last quarter's earnings report, as a result of changes in growing protocols which have been resolved. Before the end of Q3 we saw our yields return to historical levels and we have seen a meaningful increase in average cannabinoid levels in Q4 to-date.

We consistently implement continuous improvement programs with the goal of increasing yields in cannabinoid content and we'll continue to evaluate the different strains from our genetic bank to offer new products. With certification received from Pro-Cert during the quarter for organic product sales in the recreational marketplace, we determined which strains from our genetic bank to launch under our Ankr Organics brand this fall which will be cultivated in our organic growing environment.

Not all programs lead to successful improvements. However, we have the benefit of our own in-house proprietary software OrganiGrow, our software program and database which tracks the impact of changes we make and allows us to work to identify and deploy optimal methods. Of the time we completed our Phase 4 expansion, we expect to have a significant amount of additional proprietary knowledge that we can leverage across our expanded cultivation platform.

Now turning to slide 4. As I mentioned, Phase 4 is on track and in line with the estimated CapEx cost of approximately CAD 125 million. You can see some of our progress in the photos in the appendices of today's slide package. The expansion will have a state-of-the-art mechanical system to capture treat and reuse the water from dehumidification which is central to the cultivation process. Our fully customized irrigation system that will serve all of Phase 4 is being installed and expected to be commissioned in the fall of this year. Once operational, the system is expected to be one of the most sophisticated indoor cannabis cultivation irrigation systems in North America.

Construction of Phase 4A which includes 30 grow rooms was completed on schedule and we received licensing approval in two stages. As our Moncton campus is one continuous facility and all our new rooms are essentially replicas of those approved on our previous submissions, our licensing process is relatively streamlined and predictable which has proven to be a competitive advantage for us. At the end of April the first 13 rooms at Phase 4A representing about 11,000 kilos per year of increased production capacity were approved. We expect to begin harvesting the first of these rooms by the end of July 2019. The last 17 grow rooms of Phase 4A received approval toward the end of June representing about 14,000 kilos of incremental capacity, and we expect to harvest the first of these rooms by the end of September 2019.

Phase 4B has 33 additional grow rooms and is expected to be completed in September 2019 which will increase total target production capacity to 89,000 kilos per year for the Moncton campus once fully licensed and operational. During the quarter much of the electrical and control infrastructure for the Phase 4B grow rooms was installed. The initial 17 grow rooms have already been completed and the Health Canada licensing amendment for these was submitted in June 2019. In anticipation of receiving licensing, we've already begun quoting for these additional 17 rooms; the remaining 16 rooms are on schedule to be submitted for Health Canada approval in September 2019.

Our final Phase, 4C, with 29 grow rooms is expected to be completed in December 2019. All the foundation, footings, and underground services are completed with structural steel insulation ongoing in July. The team has done a fantastic job keeping the expansion on track while continuing to deliver high-quality product to our customers and patients.

We have generated strong operational and financial results fiscal year-to-date and emerged as a national leader in Rec 1.0. We have a relentless focus on automation and innovation to deliver a diverse number of high-quality products but to also ensure availability of supply in order to build brand equity. We believe we have earned considerable goodwill and brand loyalty with our customers and our partners. We are well underway in preparing for Rec 2.0 strategy with these principles at the forefront. Customers will demand choices in vaporizable products and edible offerings as well as quality, innovation, and a consistent availability of product supply. Retailers and provincial distributors are likely to become increasingly dependent on the licensed producers with a strong reputation and track record on meeting supply commitments.

We have always chosen depth versus breadth to ensure that we can keep our products on the shelves for customers. As such, it made sense for us to choose the most popular cannabis products in the edibles and derivatives market and partner with leading suppliers and reputable brands. We did just that; we have an exclusive consulting agreement with TGS in Colorado and benefited from their insights on market trends and products.

On slide 6 you can see that based on U.S. states sales history vape pens are the largest segment, at about 23% of total cannabis sales, followed by edibles which includes beverages at around 13%. We plan to launch a variety of vaporizable products in December as soon as authorized for sale followed by chocolates and a range of powdered beverage products in early calendar 2020. In terms of vape pens, we're proud of being selected as one of the four Canadian launch pod partners of PAX Era, the premium closed-loop vaporizer system created by PAX, an undisputed leader in the design and development of premium vaporizers for dry flower and concentrates. We have also partnered with the Feather Company for an exclusive license in Canada to their proprietary disposable vape pen technology and form factors.

In choosing which edible products to launch, we decided to initially focus on chocolates because we believe we can differentiate and innovate around our product offerings with chocolates. This is much harder to do with soft chewable products like gummies. We have the in-house expertise for chocolate production as our product development team have more than 25 years of experience and expertise among them. In the fall we expect to take delivery of a high-speed, fully-automated production line with capacity of up to 4 million kilograms of chocolate per year. The CAD 15 million investment commitment for this line includes a state-of-the-art chocolate molding line and a fully integrated packaging line that includes advanced engineering, robotics, high-speed labeling, and automated carton packaging.

In addition to chocolates, we plan to launch a variety of powdered beverages. Our skilled research and development team believe they have developed a proprietary nano-emulsification technology that is anticipated to provide an initial onset of the effects of cannabinoids within 10 to 15 minutes. The emulsion process generates very small and uniform micro particles, 20 nanometers in size, which means rapid, reliable, and controlled onset. With traditional edibles and beverages, the body spends a significant amount of time breaking down fat soluble cannabinoid particles which are then absorbed and metabolized in the body before any effects are felt. This results in a slow onset and extended effect which is likely the reason why the beverage product form represents a very small percentage of edibles sales based on U.S. state data.

Our nano-emulsion technology appears to be stable to different temperatures, mechanical disturbances, salt, pH, and sweeteners. Our researchers have also developed a solid form of the nano formulation, turning it into dissolvable powder for beverages. This shelf-stable, heat-stable, water-soluble, and palatable cannabinoid formulation is also expected to provide an initial onset of effect within 10 to 15 minutes. It is expected to be discrete, portable, and customers can add it to any drink they choose. Without having to secure bottling or canning equipment and incurring significant cost associated with transfer required for liquid beverages, and subject to further testing and commercialization, we expect to launch a variety of powdered beverages as early as January 2020.

Slide 10 shows Phase 5. We are refurbishing 56,000 square feet within our existing facility designed under our European GMP standards for additional extraction capacity and a derivatives and edibles production and packaging facility as well as additional office space. Primary construction is expected to be completed in October 2019, and we expect additional in-house extraction capacity to be completed by the end of calendar 2019. However, we have the capacity to build vaporizer pens in our existing facility ahead of the licensing of Phase 5 in order to be ready to sell these products as soon as they are authorized for sale in December 2019. We are also leveraging our agreement with Valens GroWorks and to-date we have strategically built up significant concentrate and extraction material for edibles and derivatives.

So, the bottom-line, we have a fulsome strategy for a range of differentiated products and we intend to leverage our strengths such that we expect to capture further significant growth when the market expands to include derivatives and edibles before the end of the calendar year. In fact, we believe the Canadian market is positioned to grow significantly with the upcoming legalization of edibles and derivatives and importantly with more retail stores opening particularly in the key provinces of Ontario and Québec. Our fiscal 2020, starting in August, presents tremendous opportunities for us to materially grow sales and profit. As I mentioned, our yield per plant has returned to historical levels at the end of Q3 and into Q4 coupled with some of the highest cannabinoid levels we have seen as a company. As a result, we expect cultivation cost to decrease in Q4 and Q1 fiscal 2020 as we expect to realize economies of scale from our expansion.

The sales of derivatives and edibles are expected to be launched in a more mature Canadian market from a distribution and retail perspective. Ontario has announced tripling its stores to 75 in October; Québec is planning to more than double its retail presence with plans to expand from 16 stores to 40 by next March; and while Alberta has not provided a specific target, the number of retail outlets has continued to grow to about 176 stores to-date. We believe edibles and derivatives will be highly appealing to consumers, and through our exclusive consulting agreement with TGS we have great insight into anticipated market trends and consumer preferences based on experience in other mature markets. We know that the margin on these products is often considerably higher due to lower cannabinoid content. Ultimately, the margins on these products come down to the efficiency in the production of the consumer packaged goods products.

We have ensured we have the expertise and experience supported by state-of-the-art technology and automation; again, the same tenets that have allowed us to be successful in producing high-quality flower, pre-rolls, and oil at one of, if not, the lowest cost of cultivation in the industry. You can see some photos of our existing automation in our facility in the appendices which I know some of you have seen at our facility in person.

I will now turn the call over to Paolo.

Paolo de Luca

Chief Financial Officer, OrganiGram Holdings, Inc.

Thanks, Greg. Q3 net revenue was CAD 24.8 million from approximately 3,926 kilograms of dried flower and approximately 5,090 liters of oil sold. It was comprised of CAD 21.8 million in rec sales and CAD 2.8 million in medical sales, with a negligible amount coming from other items. Q3 contributed CAD 64.1 million of net revenue year-to-date for the nine months ending May 31, 2019. Q3 net revenue declined slightly from Q2 mainly due to the timing of initial shipments to Québec that occurred subsequent to Q3 quarter end and a large pipeline fill to Ontario in Q2 of fiscal 2019 which was not matched by recurring orders in Q3 of fiscal 2019 and fewer re-orders from British Columbia on account of its unique market conditions. As Greg mentioned, we expect Ontario to do another pipeline fill in August or September ahead of the next 50 store openings slated for early October.

Most of our Québec sales that started in Q4 are directly to the retail stores themselves and there is no pipeline fill that is experienced like there is for a province like Ontario which uses a centralized wholesale distribution model. Ontario where the majority of sales are now being conducted in physical retail stores will, in the infancy stages of the rec market, have more "lumpiness" in terms of sales patterns as it prefers large warehouse pipeline fill orders and has placed caps on retail store drawdowns to ensure ongoing availability of supply to the stores. We understand why Ontario has taken this approach and are working with the province and the stores to help the business flourish in the long run. We expect that as the retail distribution points increase not only in Ontario but nationally that smoother and more predictable sales patterns will emerge.

On the cost side, our Q3 cash and all-in cost of cultivation, and the non-cash items are depreciation and share-based compensation, were CAD 0.95 and CAD 1.29 per gram respectively. The increase from Q2 was almost exclusively due to the temporary decrease in yield per plant as a result of a temporary change in growing protocol that Greg alluded to earlier. Since yield per harvest returned to previous levels toward the end of Q3 and into Q4 and because we anticipate increased efficiencies in harvested yield amounts with grow rooms scaling from 52 to 82 with our Phase 4A rooms coming online, we believe that our cultivation cost should decrease in Q4 fiscal 2019 and Q1 fiscal 2020.

Cost of sales on a dried flower equivalency equaled approximately CAD 2.70 per gram in the quarter. Included in that figure is the cost of cultivation which I just alluded to; packaging costs, both material and labor; and shipping as well as any waste and packaging material write-downs. We believe that the all-in cost can decrease over time as we bring cost of cultivation back to historical lows and as we bring significant efficiencies to our labor per unit. While our harvest and production capacity are increasing exponentially, our staffing is not expected to increase anywhere near that much as we move from approximately 700 employees now to an expected amount of 850 employees by calendar year end.

As a company, we focus more on adjusted gross margin and adjusted EBITDA which exclude fair value changes to biological assets and inventory as key measures of our underlying performance and find this to be what analysts and investors tend to track. As noted at the beginning of the call, these measures are non-IFRS financial measures and we encourage you to review our Q3 report for more information including a reconciliation to comparable measures under IFRS.

Q3 adjusted gross margin was CAD 12.3 million or 50% as a percentage of net revenue and year-to-date adjusted gross margin was CAD 37.1 million or 58% as a percentage of net revenue. Compared to last quarter, Q3 adjusted gross margin reflected higher production cost, a temporary decrease in yield, and write-downs on legacy packaging materials that were replaced with new, more consumer friendly packaging. Q3 IFRS gross margin was negative CAD 0.2 million largely due to fair value changes to biological assets and inventory.

Adjusted EBITDA of CAD 7.7 million or adjusted EBITDA margin of 31% as a percentage of net revenue was positive for the fourth consecutive quarter. Year-to-date, adjusted EBITDA was CAD 27.8 million or 43% as a percentage of net revenue. We continue to be disciplined in our approach to spending this quarter. Q3 sales and marketing and general and administrative expenses or SG&A were CAD 9.1 million or 37% of net revenue, and year-to-date SG&A was CAD 19.3 million or 30% of net revenue which starkly contrasts with many of our peers.

I'd like to take a moment to highlight what we believe to be a significant differentiator between us and our peers. We are obviously aware of the massive market opportunity that exists with the legalization of cannabis in Canada and the wave of medical legalization that is being seen in other countries around the world, and we understand that significant investment in those opportunities is needed. However, we aim to approach our business activities with the level of discipline that hopefully sets us apart in this space. Not only have our margins been good but we've kept our SG&A in check. Our executive compensation is modest compared to our peers. Our sales and marketing spend is also modest compared to our peers. We are not operating out of multiple facilities with disaggregated management teams and different SOPs but from one centralized facility where we can drive economies of scale more easily. Based on current expectations our cultivation and harvesting capacity will increase by over three times from the early part of calendar 2019 to the same point in 2020. As we scale our number of employees, per unit of production is expected to decline as we optimize production practices and introduce efficiencies.

We believe that many other industry participants have assumed that access to capital is never ending and have been funding operating losses with continued dilution to shareholders. What we are trying to do at Organigram is build a company with a sustainable business model which is capable of doing more with less. We have tried to be profitable right out of the gate of Rec 1.0, and have largely achieved that, and plan for more of the same for Rec 2.0. We highly encourage investors to pay attention to operational and efficiency metrics.

Our Q3 net loss from continuing operations of CAD 10.2 million or CAD 0.07 per share on a fully diluted basis was largely due to non-cash fair value changes to biological assets and inventories. Year-to-date, net income from continuing operations was positive CAD 12.9 million or CAD 0.09 per share on a diluted basis. Again, we do not focus on net income or loss to assess or underlying performance due to the impact of fair value changes from period to period on biological assets and inventories.

Moving to the balance sheet, we have built liquidity with approximately CAD 88 million in cash and short-term investments at the end of Q3. During the quarter we converted the remaining balance of debentures, and this eliminated approximately CAD 49 million in current liabilities from our balance sheet. We also closed a CAD 140 million traditional debt financing at attractive rates which includes both a term loan to finance our expansion plans and a revolving debt for general working capital and corporate purposes. Included in the facility is an uncommitted option to increase the term loan and/or revolving debt by an incremental CAD 35 million to a total of CAD 175 million, subject to agreement by the lender's satisfaction of certain legal and business conditions. To-date, we've drawn down on only CAD 50 million of the credit facility, leaving at least another CAD 90 million eligible to be drawn.

I will now give the floor back to Greg for his closing remarks.

Gregory Engel

Chief Executive Officer and Director, OrganiGram Holdings, Inc.

Thanks, Paolo. There's no question we're excited about the future, and we often get asked about our plans once the time when supply meets demand in the Canadian market. First, we believe the U.S. and international markets represent tremendous opportunities particularly in the CBD market, and we absolutely plan to further participate in these markets subject to compliance with applicable laws. We're hard at work on this opportunity. Again, our priority is to deploy disciplined capital allocation with a focus on achieving sustainable and attractive return on investment for our shareholders. Over the next while the Canadian market represents a significant growth opportunity. Supply will meet demand one day but we are confident that our strategy is designed to not only maintain but grow value for shareholders.

Our indoor facility means we produce high-quality dried flower which has seen very little price compression in mature U.S. markets, and our investment in biosynthesis is expected in the future to offer us access to the input materials for derivatives and edibles at a fraction of the cost of traditional cultivation. In fact, biosynthesis has many advantages over traditional cultivation, particularly that about our cultivation in greenhouses. These include reduced operating and capital costs; scalable, consistent, superior purity and quality of product; a smaller environmental footprint; and the ability to meet even more rigorous standards of CPG and pharma. In closing, I'd like to thank the Organigram team for their significant efforts and delivered to-date and preparations for the next exciting chapter in our history.

That concludes my formal remarks. Operator, if you could go ahead and open up the line for questions?

QUESTION AND ANSWER SECTION

Operator: Thank you. Certainly. [Operator Instructions] Your first question comes from the line of Oliver Rowe with Scotiabank. Your line is open.

Oliver Rowe
Analyst, Scotiabank Global Banking and Markets

Q

Good morning and thanks for taking my questions. On the operational side, sales pulled back despite overall industry sales increasing, so that's sort of implying a decline in market share. Could you help us separate the temporary impact in the quarter in terms of, from Quebec and BC, from a general increase in market competitiveness, and I guess if you expect to regain that market share in the coming quarters?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. Thanks for the question, Oliver. So I think you have to look at kind of in totality across the Canadian market. We were seeing significant growth as alluded to in both Alberta and Atlantic Canada and Ontario is a significant part of the market. While sales into Ontario were lower in Q3 versus Q2 because of the pipeline fill, it doesn't necessarily mean there was a shift in market share because they would have been and continue to be working through. As you know, they have a cap of 25 kilos per store per week and so they're working through part of that pipeline build. So I don't have necessarily a market share number kind of nationally, but I wouldn't look at kind of inbound pipeline fill and then you have to consider what's happening as that product gets worked through in the majority of markets, and then again were through in Québec after the quarter. So again, that's a new market for us going forward.

Oliver Rowe
Analyst, Scotiabank Global Banking and Markets

Q

Right, that makes sense. You mentioned an interest in U.S. and international CBD markets. Can you maybe just update us on your Serbian hemp play and if we should expect to see some more M&A or developments in Europe to facilitate that market? And then maybe just high level thoughts on what a U.S. CBD roadmap might look like?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. So our investment in Eviana continues to progress. So certainly, as we've made aware before, they've been harvesting high CBD content hemp in both Croatia and Serbia the last three years. They have had a pinch point in extraction, building out their own internal extraction. So they are looking to outsource some of that. They don't have current capacity just to use all the hemp that they produce. So we're looking to assist them in that process by finding another third party to help get through that, and then we're looking to access that CBD to further expand our efforts. We do also have an investment now for cannabis in Germany which has a synthetic CBD on the market in Germany right now sold through up to 5,000 pharmacies based on their distribution agreement. But we are looking at other opportunities; we see the kind of nutraceutical health and wellness side of CBD in Europe as a significant market opportunity.

In the U.S. we're very actively looking at what the opportunities present from a CBD perspective. We are not necessarily looking to be a cultivator. We're seeing kind of already pricing compression happening on the hemp side in the U.S. but we want to play at some point in the value chain. And it really comes down to what the regulations are going to look like. I mean, we certainly have been following the activity of the FDA. We have seen recently some restrictions like in New York State to clamp down on the use of kind of oral consumption products, and that certainly was one of the key aspects that the FDA highlighted in our public hearings back at the end of May. And so we're very much focused on looking at how can we participate as the regulations evolve there, so nothing in place today but we're certainly looking at a number of different opportunities.

Oliver Rowe
Analyst, Scotiabank Global Banking and Markets

Q

That's helpful. Thank you.

Operator: Graeme Kreindler with Eight Capital, your line is open.

Graeme Kreindler
Analyst, Eight Capital

Q

Yeah. Hi. Good morning and thanks for taking my question. I just wanted to get some more color. I appreciate the commentary around the [indiscernible] (00:30:06) the Ontario pipeline fill. I was just wondering considering the harvest for OGI declined quarter-over-quarter, I know there's a significant amount of inventory on the balance sheet right now. But will this have any knock-on effects in terms of product available for sale or volumes available for sale in the fourth quarter?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

No. I mean, again, it did have – and maybe I'll add a bit more color in the MD&A. So the change that we did make in terms of our processes was we did a small scale pilot study to look at taking clones from flower, plants and flower versus plants that we have specifically designated for vegetative growth. We're unlike other companies where we don't clone from mother plants; we actually clone from veg. The pilot scale study was very promising, so as we expanded to a larger scale we didn't see that play out in a positive manner so we reverted back. So certainly, as we alluded to, before the end of Q3 and certainly in all of Q4 to-date we're seeing back to our historical levels of production. So as you said, with the inventory level that we have it certainly should not have an impact on our ability to kind of meet the market demand. We expect Ontario, for example, to do another pipeline fill at some point in August or September and certainly as they prepare for the additional 50 stores to come online.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay. Thanks, Greg. And as a follow up there, I know the press release mentioned having some lower cannabinoid content in the product that was harvested. So could there be any knock-on effects? I know your pricing was relatively flat quarter-over-quarter, but could that potentially impact pricing moving forward for some of that inventory?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

No. I mean, so what we commented on was the fact that our actual cannabinoid levels are increasing, so we feel that we've come to kind of a great balance now of cultivation and yield in conjunction with higher cannabinoid levels, right? So that's kind of been the shift. So it wasn't that in the past quarter we have lower cannabinoid levels; it was that in Q4 and the end of Q3 we were going to higher than historical cannabinoid levels which should have a positive impact too.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay.

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

A

Yeah. Graeme, it's Paolo here. In fact, we're always keeping track of all these particulars. Where we are right now in terms of our harvest, we're getting probably the best yield and cannabinoid levels that we've ever had at the same time. Like, we've had instances where we had higher yields and with an incidence of higher cannabinoid levels. But at this point in time, the harvest that we're getting off our facility now are the best of both worlds that we've ever had kind of hitting on both cylinders.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay, understood. Appreciate the color. Thank you very much.

Operator: David Kideckel with AltaCorp Capital, your line is open.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Hi. Good morning. Thanks for taking my call and congratulations on the quarter, everybody. Just have a couple questions here. I want to kick it off first with your big potential U.S. and international strategy here. So first, just understanding the U.S., and CBD and hemp in particular, if the U.S. is going to be of strategic importance to OGI would you be considering using the CBD from hemp or would this be CBD from say cannabis altogether just to remain compliant with U.S. law?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. So again, our focus is we're not looking at this point to be a hemp cultivator or producer. We've seen some other companies make that decision in the U.S., so we would be very much focused on CBD from hemp for the United States market because that's what the Farm Act and what we're seeing the regulations allow. I think, David, you and I have spoken about this before. Where we see future opportunities is certainly biosynthesis as an input material for many products there. And even to the point where as Hyasynth continues to kind of build out their expertise has actually potentially put a biosynthesis facility somewhere in the United States to produce within that jurisdiction for use of product or to export from Canada into the U.S. from biosynthetic CBD. So it's a combination of both.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay, that's actually very helpful. So that actually was going to lead me into my next question, Greg, with respect to Hyasynth. So the U.S. is on Hyasynth's radar then. Just from a distribution and R&D standpoint, shouldn't we be thinking of Hyasynth now as more of an international play, not just solely Canadian?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. I think Hyasynth presents a tremendous number of opportunities, right? If you think of biosynthetic production of CBD or THC or other minor cannabinoids, they've already synthesized THCV and CBDV. That lends itself very well to a more traditional CPG or beverage alcohol company looking for a kind of pure, ongoing input material. It also lends itself to potential opportunities from pharmaceutical companies. We know that there has been interest in pharma companies at looking at cannabinoids in general but one of the challenges they face to-date is accessing them from plant-derived material, and biosynthesis is really kind of in the bailiwick of what pharma companies do and many companies are producing products today through biosynthesis. So they're familiar from it and I think this would present a unique way to produce potentially unique pharmaceutical products with a combination of major and minor cannabinoids in the future.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay, that's great. Thank you for that color. My last question and then I'll get back in the queue. How should we be thinking about – Paolo, as you were mentioning early on the call about gross margins for the next quarter, should we be thinking that gross margins will stay in this range or due to the sort of temporary I guess protocol changes and other changes that occurred in the quarter do you expect margins to improve for the next Q4?

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

A

So for Q4, I wouldn't make a call either up or down just because Q4, the visibility on it, is still going to be dependent on a sales perspective whether we get the pipeline filled and so forth. I think certainly and for fiscal 2020, the first couple of quarters there where we're still selling dried flower and oil and potentially also vape pen, I would expect our efficiencies to definitely improve because our cost of cultivation is going to be back to where it was before. And certainly our staffing – I think I made mention to this on the call, and I think this is an important metric that people should be looking at at peers as well is what's your revenue per full time employee going to be in a more mature market? We have enough staffing now to handle almost all our growth, and so we have the benefit of even improving upon that with automation and so forth. But right now we're staffed up to be responsive to the large purchase orders that come in, and so we've made the sacrifice to capture sales which we're one of the leaders in sales since Rec has been launched and those efficiencies will definitely come I think starting in Q1 and Q2 of next year.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. And maybe just to add a little more color to that, Paolo, is previously in the past we had mentioned that if you kind of asked this question about six months ago, what our staffing needs would be when we're fully built out, and we were talking of a number of around 1,000 employees. So based on the continuous improvement projects and the amount of automation we've brought in we certainly believe that we're now only going to need 850 which only would be an additional just over 150 employees from our current base even though our production capacity is still going to more than double where it is today and we've got new forms. We've just continued to add two automation systems and we improved kind of what we're doing on a day to day operations basis which again should contribute to us from a costing basis.

Paolo de Luca
Chief Financial Officer, OrganiGram Holdings, Inc.
A

Yeah, and from our perspective where we realize we still haven't hit our peak efficiency and we still haven't hit our peak economies of scale and yet we're still showing positive EBITDA margin. And we're delivering in a market right now that's not mature from a retail perspective, like we haven't been in Québec; Ontario is the largest province – it needs more retail stores, I think everybody realizes that. And we haven't even done Rec 2.0 which represents 50% of the market. So, we're excited that we're able to generate positive EBIT margin now and I think that bodes well for us in the future with these opportunities both from our perspective on efficiencies and from the market to double, organically grow because of legalization of Rec 2.0 and obviously the increase in retail endpoints.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.
Q

Okay. Thanks very much. That's very helpful. I'll hop back in the queue.

Operator: Tamy Chen with BMO Capital Markets. Your line is open.

Tamy Chen
Analyst, BMO Capital Markets (Canada)
Q

Yeah. Thanks. My first question is I just wanted to get an update on Ontario. So, are they still implementing that retail allocation? Have they ordered a bit more ahead of the August pipeline fill or is it still just you're not expecting much until that big August pipeline fill comes in again?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.
A

Yeah. So, what they've been doing, Tamy, and thanks for the question is – so, they do have this 25-kilo max on a weekly basis. They did expand and put three products outside of that max. We have one of those SKUs so – that are included outside of that, so our trailblazer product is not under the 25-kilo cap. So that does give us an opportunity to just sell product in.

Depending on the SKUs, they have been refilling some. But what they're looking for again is they've got sufficient inventory. When you actually look at kind of their warehouse and inventory numbers, they are concerned about not running out of inventory but they certainly have many, many weeks of inventory right now with the exception of a few SKUs across a few companies. So, they will be placing – they tend to want that kind of in advance of stores coming online to get that large pipeline fill to expand their warehouse capacity.

So, we expect to see that in August or September, which again could have something that impacts our quarter based on our Q4 ending at the end of August, right? So, if the order goes in August, we're preparing hopefully and optimistically to get it out before the end of August, but it's dependent upon them.

Tamy Chen
Analyst, BMO Capital Markets (Canada)
Q

Okay. Thanks. And my second question is I was wondering if you could give more insights to the Alberta market. They're the only province really being more aggressive on retail store openings. And it looks like for this quarter, your volume sold was basically flat from the prior quarter. I would've thought that notwithstanding the issues in Ontario and the time in Québec that just given where Alberta has been doing with their store rollout that it still should have contributed to some level of sequential growth. So, can you talk a bit about that market?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc. A

Yeah. So, I mean, certainly for us, Alberta is a significant growth. Quarter over quarter, we almost doubled our sales in Alberta to the Alberta – kind of to the AGLC. So, certainly, Alberta and the Atlantic Canada and provinces we've seen consistent growth kind of quarter over quarter. But, again, Ontario with such a large pipeline fill had such an impact of not in Q2 not having that replenishment in Q3 had an impact. So, while Alberta, Atlantic Canada grew, Manitoba grew for us as well. And we see that ring. Alberta is adding – originally, they were going to add 10 stores per week. The last couple of weeks, they've added 20 per week.

I think the one thing we didn't highlight in any detail here is British Columbia. B.C. market has been more challenging. They are just now adding some additional stores. But what we're seeing in British Columbia is that so for unique form factors, good success there, but for dried flower, that is a market that's challenging to penetrate. So, B.C. sales for their dried flower are limited due to the kind of unique nature of the marketplace. And this is consistent across every company, right? I mean, people are selling – we're selling certainly pre-rolls into their companies and oils. But certainly, companies that have capsules as well, those are doing well. But dried flower is still very limited in B.C. through the retail stores.

Tamy Chen
Analyst, BMO Capital Markets (Canada) Q

Okay. And just to confirm in Alberta, you mentioned – so, for example, with Ontario, you've got the centralized buy-in so it causes some of the lumpiness. Does Alberta function like that at all?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc. A

They do but because their throughput is so high, they're ordering on a more consistent basis. So, because now with over 150 stores, what we're seeing is weekly orders out of Alberta, right? So, they've got a bigger store population to fill whereas Ontario made a decision to build a big inventory in their warehouse and then slowly work through that. Alberta is replenishing on an ongoing basis.

Tamy Chen
Analyst, BMO Capital Markets (Canada) Q

Okay. I see.

Paolo de Luca
Chief Financial Officer, OrganiGram Holdings, Inc. A

So, Tamy, we view Alberta as where Ontario will be and that gives us a lot of optimism obviously because it's a more smoothly functioning market at this point in time. And so, that's – because even though it's a smaller market, we're actually getting more growth in Alberta. And therefore, when Ontario kind of starts to match the retail endpoints, we'd expect the same type of growth in Ontario.

Tamy Chen
Analyst, BMO Capital Markets (Canada)

Q

Got it. Okay. And my last question is just back on the gross margin, it sounded like in your prior answer to the prior question that in fiscal Q4 that some of these headwinds may not be fully through. Am I hearing that correctly?

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

A

Yes. And it has – a lot of it has to do with like our cash cost or our cultivation cost are just one component of the mix, right? So, we're running right now with what I'll call and it's tax – we're doing this for strategic reasons. We're running with a sub-optimally inefficient labor pool because we want to be ready for the increased volumes that come out. So, by the end of July in a couple of weeks here, we're harvesting from Phase 4A. We've gone from 36,000 kilos to 61,000 kilos above annual targeted production.

So, we can't just displace the labor pool and then bring them back. So, we have that labor pool. And once that apparatus is working on a larger volume of product, which is going to be shortfully, we're going to see those costs come down again. So, I think, our quarter-end or year-end is August 31. I think it would be reasonable to assume that we have these kind of – these margin – kind of slight compression to margin for Q4, but I would expect in Q1 and Q2 definitely for it to go back to very attractive levels.

Tamy Chen
Analyst, BMO Capital Markets (Canada)

Q

Okay. Understood. That's all for me. Thank you.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Okay. Thanks, Tamy.

Operator: Matt Bottomley with Canaccord. Your line is open.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Yeah. Thank you for taking the questions. A lot of mine have been answered. I just wanted to stay on the cultivation side, and apologies if you did go into some details last earnings call, but when it comes to the – what you call the change in growing protocols, can you just give a little further color? Is that something that was changed wholesale in the facility where the cost – or where the margin pressure was felt this quarter or was it something more transient and just part of your facility that you had to change?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah. So, as I alluded to earlier about, we made it – we did a pilot study on a small number of rooms where we – if you recall, our technique is very different than other companies. We don't clone from mothers. We actually overproduce vegetative plants specifically to clone from them, so that we get a much healthier and vibrant clone. So, we did a trial to see if when we go through and trim on flower plants, on the early part of their flowering cycle, whether or not we could use that for cloning. It would improve efficiency. We'd reduce the number of vegetative plants we have to produce.

So, the early trials were very positive and directionally gave us comfort to say we could do – we could do this on a broader scale. So, we did move to that change and what we saw is that that trial may have been very unique to a couple of strains there we could successfully do that with. So, when we did roll it out and we picked up kind of that challenge within a number of weeks, but as you can imagine that we had already planted a significant number of rooms with that revised technique and then for us to revert back to cloning from veg took some time to do.

So certainly, what we saw is well before the end of Q3 and certainly all of Q4, we are back at historical yield levels that we kind of pride ourselves on. And with some of the other changes we've made, we're also seeing really high and positive cannabinoid levels for us. So it was a test we did. The early trial looked promising. When we used it kind of broadly across more strains, it didn't give us the results we wanted. It had a pretty significant impact on kind of the vibrancy and the yields from those plants.

But you have to make a decision four weeks into the lifecycle of the plant, do you destroy then start from scratch or do you see it through its growth cycle? Still had decent results but certainly not what we historically expected. So that was why you saw a big impact on cost of cultivation and also that did impact our biological assets as well.

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

A

Matt, and yeah, and we keep – we obviously keep track of the harvest very carefully and I could tell you that the last 30 harvests, not only are they back to normal levels, the cannabinoids profile is excellent. And what I think a lot of comfort in is the range of distribution on the yields we get per harvest is very narrow which tells me that we've really locked in the predictability of the yield. So we're very confident on the yields going forward and we're excited to have new rooms coming on and getting harvested in a couple of weeks.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Great, thanks. Just want to move to the sort of the cannabis 2.0 side of things. So given your commentary over really trying to get to hit the ground running here with vape pens and chocolate edibles, in both of those categories, are you able to tell us what you're able to inventory in advance of the – assuming everything goes out the door or some sales start in mid-December, that might presume that you have to ship at end of November? What are you able to do today? I imagine you [ph] got empty (00:49:33) vape pens, but in both of those categories in order to get ahead and potentially start with a leading share in those categories.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yes. So, I mean, we can't specifically say what amount of product inventory we'll have. So certainly between the PAX Era and Feather, as well as the medicinal value 5/10 cartridge, we have or will have shortly kind of significant inventory of all that equipment and filling and all that kind of pods and/or pens.

We do have, however, significant inventory of concentrate, right? So one of the key things when you look at our MD&A, one of the things we highlight is a very big shift from material for extraction. We already have at the end of the quarter, and this trend has continued, 312 kilos of 70% concentrate cannabinoids.

And again, we're working through additional material both internally and with balance. So we've got a lot of concentrate material that will help us kind of be prepared. So we will definitely be in the position to have a range of vaporizable products for the December launch. What's still to be determined, as you said, Matt, is whether or not we'll be able to ship those in November into the retail chain or we have to wait until December. We really don't know yet from Canada, even though we know there's a 60-day notice.

One comment I would make is we actually, today, submitted all of our product forms for Rec 2.0. We wanted to be in the queue for the review cycle. So, today was the first day as companies could do that. So, we've already made those submissions this morning.

And then for chocolates and powdered beverages, so we want to have sufficient inventory before we launch those products. So, I don't expect us to launch chocolates until January at the earliest. And I think that is going to be very much dependent on how much the inventory we have. One of the things we've talked a lot about before is it doesn't do you any good to kind of have intermittent supply in the market. But, I mean, the good news is our equipment is capable of producing very high large volume throughput. This is the same type of equipment you would see in some of the largest chocolate facilities in the world. And as we're building up extract material, so we expect to build through all of our backlog in the material before the end of the year between both internal resources and external resources.

Matt Bottomley Q
Analyst, Canaccord Genuity Corp.

Great.

Paolo de Luca A
Chief Financial Officer, OrganiGram Holdings, Inc.

Yeah. And just some color on the concentrate. Obviously, I think you're probably aware but just for some of our listeners, 312 kilograms may not sound like much, but when you're putting 10 milligrams into a chocolate, you can produce millions of units, right? And even for vape pens where you're putting, call it, 250 milligrams or 500 milligrams of cannabinoid and concentrate, those are big numbers we can drive up by concentrate, and we have more of that coming.

Matt Bottomley Q
Analyst, Canaccord Genuity Corp.

Understood and thank you. And then lastly, just staying on this topic, though, in terms of the infused beverage or potential infused beverage market, do you have – where on your priority list is potentially securing a big alcohol partner, if at all, if that's sort of on your radar right now?

Gregory Engel A
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

Yes. So, we've been very public and we're actively seeking. So, either a CPG partner that's looking to do CBD beverages or big alcohol company that's looking to do THC-infused beverages, which is why we've done the work on our liquid formulation as well as our partnership with biosynthesis. So, definitely high on our list, certainly something management is spending a significant amount of time on. What it is really dependent upon is the status of those potential partners, right?

What we've seen in discussions with potential partners is kind of varying levels of commitments where they seem to move close to making a decision and then kind of go back as they're looking. And because you have to consider these are global companies and they have to look at global implications, these types of decisions have to go to – through their boards and have to be reviewed by legal compliance and a lot of areas like that. So, definitely a key aspect we're focused on but certainly nothing to announce at this point.

And just make one additional comment. The reason we're excited about our powdered beverage, I think the powdered beverage formulation is one that in our discussions for those of you on the call it or where the provinces over the last few weeks have been doing product calls. They've been asking for companies for a full broad range of their products and commitments and pricing. As far as we've seen in any of those discussions, we're the only company and we've got this feedback to have a powdered beverage option. And I think what the uniqueness of that option is you're creating an input material that people can choose to make the beverage of their choice and to consume at the time that they want to. Certainly, big savings for us in terms of shipping costs, production labeling costs, but also for the retail stores.

I think one of the challenges some of the other beverage companies are going to have is securing sufficient space within a retail environment. Many of these locations were not built out with the consideration to have refrigeration and or large storage for kind of the volume that beverage products are going to take. I mean, edibles in and of themselves are going to be a whole new SKU range and a lot of products but still having that kind of discretionary package and small-volume package that people can create any beverage they want that that's going to be fast-acting is a big advantage.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

Yeah, we're going to sell the rum, not the rum and coke.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Very helpful. Thanks, guys.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Thanks, Matt.

Operator: Greg McLeish with Mackie Research Capital. Your line is open.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

Hi, guys. Just a couple of questions. Given CannTrust's issues that they had last week, do you think that there's an ability for you to gain market share from the fact that they have had product pulled from OCS and also the ability to potentially poach some of their large patient base of medical clients?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah, that's a great question, Greg. So, I think certainly we've already seen some inbounds from provincial authorities asking us about additional product availability with what we've seen with CannTrust's decisions that are being made. I think certainly from a patient perspective, the last report I saw was that they had 72,000 patients.

We have been seen as a company of pretty ongoing steady shift of patients converting over to us from other licensed producers, and I think this goes back to the Rec launch in the fall. We were one of the companies that made a very firm commitment to supplying our medical patient population base and have always consistently had product available for them whereas other companies had issues and had infrequent available products. But that being said, we would not necessarily be in a position to take on an additional couple tens of thousands of new patients at this time. Just in terms of product allocation, we can certainly gradually take our new patients and we already are starting to see some of that happening.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

Great. And on a – just on a macro basis, do you think that Health Canada will do a disservice to the industry if they don't permanently revoke CannTrust's licenses?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

It's an interesting question. I can't necessarily comment on their decision making. I think what we have seen in the past, we believe was a decision that was made there with a product that was brought in from the black market – may be indicative of what we may or may not see here. But I can't comment on what Health Canada is going to do.

I think one of the things that I would highlight though is we're seeing a transition in the industry right now. I think one of the key things that we have seen with over the years and I guess I look back and it started with when I joined Organigram is a transition from kind of founders, as leaders and CEOs of companies, to bringing in kind of different people that have experience in building and growing companies or running and operating successful companies. And that transition continues right now.

Certainly, we saw that with Canopy with the recent change. But I think that what it hearkens to is, it's really important that companies have independent governance and we know that the governance is – we're really proud of the fact that we have an independent chair and a fully independent board with the exception of myself, sitting on the board. That's not necessarily the case of many of the other companies. And I think it's – or historically was not the case and it did lead to some challenge at those companies. So.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

Great. And just to clarify, that was – you mentioned, believe, but wasn't it Bonify?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Sorry. Bonify, sorry.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

Yes.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

I apologize.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

No, hey...

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Okay, thank you for clarifying, Greg.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

No worries.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

I appreciate that.

Greg McLeish
Analyst, Mackie Research Capital Corp.

Q

I'll get back in the queue, thank you.

Operator: Justin Keywood with GMP Securities. Your line is open.

Justin Keywood
Analyst, GMP Securities LP

Q

Good morning. Thanks for taking my call. Given there's been a detailed discussion on the different cost items so far, just more broadly on the key performance indicators of adjusted gross margins and EBITDA, any expected ranges or goals for those metrics in Q4 and going into 2020?

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

A

Yeah. So for Q4, it's like, I would say, Q4 more of the same as Q3 but really the eye on the prize for us is 2020 because it's just a bigger market opportunity obviously with Rec 2.0 and obviously with significantly more harvested production coming online for us and obviously the expansion of the retail end points across the country. So we would expect our margins actually to revert back to our previous or some of the previous numbers that we've achieved. So I think – I don't think that we – I think we can beat what we did this quarter certainly in Q1 and Q2 of next year. And ultimately, longer term, it's going to be dependent on obviously the way that the Rec 2.0 market develops, what kind of pricing power is available there and the costing and so forth.

So we think we have all the tools to be a leader in terms of capturing margin because we have the lowest cost of cultivation and because we have also in terms of biosynthesis and ability to even get better on that, as well as to be able to drive efficiencies out of one large facility as opposed to having scattered facilities across the country. And again, we're – because of our indoor quality – indoor growth, high quality products, we think we also keep the margin on the flower up point. And this very few – very small percentage of the production in cannabis being grown indoor and we think that offers us a level of consistency and quality that some of the greenhouses can't achieve.

Justin Keywood
Analyst, GMP Securities LP

Q

Thanks, that's helpful. And I realize it's early for the Rec 2.0 but any indication on what the gross margins could be for these derivative products?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah, I think we – and I mentioned this, Justin, in the call. I think you have to look at the products very differently between the categories. So, for vaporize pens and that technology, the cannabinoid content is quite high. So then it is dependent upon your cost of cultivation and your extraction throughput and efficiency as well as your ability to fill those products. So, that is very much indicative of the margin will be related to your production costs and your conversion cost.

When you move into edible products and beverages, the cannabinoid content is a very small fraction of the ending product. So, it really comes down to your throughput efficiency. So, that's why on chocolates, for example, that we've gone to leading manufacturing equipment that we believe we'll be able to produce products at a very low cost. We become then a consumer packaged goods company and the cost of producing that consumer packaged goods is critical.

And so, we do know it's one of the aspects of our partnership with The Green Solution or TGS in Colorado. We do see what their margins are and we know at a lower production level where they're one of the leading providers in Colorado. I believe they have around a 9% share in Colorado in total but they still do things semi-automated versus the automation at a very strong margin. So, I think we don't have numbers yet, but we certainly have expectations that certainly our ability to produce those products is going to be a big driver in the margins that we'll receive on those products. But in general, the margins on those products are higher than on dried flower.

Justin Keywood
Analyst, GMP Securities LP

Q

Okay great. Thank you for taking my questions.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Thanks, Justin.

Operator: Alec Patterson with Allianz Global. Your line is open.

Alec Patterson
Head-US Consumer Research, Allianz Global Investors

Q

Yes. I just was hoping to get a little more color on the PAX relationship in terms of will you be the seller of the finished goods or will they be? How does the sort of accounting of the relationship play out in the sales and production and the costing of all that?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Sure. No, it's a great question, Alec. So, the structure with PAX is that they're going to be selling the devices across Canada. They actually have set up an organization here in Canada, and they hired a key person from

Nova Scotia Liquor Corp to head up as President of the Canadian organization. So, what we will be doing is getting the pods from them and filling them and we will be then selling them to the retail stores. So, part of the agreement is a royalty structure based on us filling and supplying those to the marketplace. And so, again they'll position to make sure that there's product distribution of the PAX Era device and then we'll be selling the pods into the marketplace.

Alec Patterson
Head-US Consumer Research, Allianz Global Investors

Q

So, you're the razorblade part of the equation?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Exactly. If you use the disposable razor analogy, certainly.

Alec Patterson
Head-US Consumer Research, Allianz Global Investors

Q

And in terms of the size of the market, just wondering if there's anything about the Canadian market that differentiates it from the templates being laid out in Colorado and Nevada and California. In terms of the percent of the market that the vape market has taken which I seem to recall is around 20% or 30%, is there anything unique about Canada that's going to impact that scalability?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

I think the only thing we're possibly going to see, Alec, is that at the early stages of the launch of Rec 2.0 in Canada is that vaporizer products, I think, will be one of the dominant forces in terms of what's available. Even ourselves, we've indicated that we won't be launching our chocolates and our powdered beverages until kind of early part of 2020 Q1. So, I think you'll see a more dominant position at the time of launch the vaporizable products here. When you look at data from any U.S. state, you're looking at a more mature market with a broad product offering, right? So, I think it's going to be a – it's part of the critical aspect of why we've got a multi-pronged approach with PAX Era, with Feather, and then with also another 5/10 disposable cartridges, we want to go aggressively into that market because those are going to be the really dominant products that are available because the other ones are more complex to produce that scale for companies.

Alec Patterson
Head-US Consumer Research, Allianz Global Investors

Q

And just lastly, how do we think about the mix effect of the gross margin structure of value-added products like the vape pens? And is there a better way to track the profitability and return on the business as you migrate more into these derivative products?

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

A

Yeah. It's an excellent question, and it is one that we struggle with internally because the market in Canada obviously is unique in the sense that it's the first kind of market of that's legal on the scale. And so, what we can only really do is look to what's been done in the U.S. and the information that we can get from our partner there, TGS. And we've seen – certainly as we've mentioned before, we've seen margins on these derivatives products in many cases be higher. But having said that, until we actually produce the product and establish pricing with our buyers, the provinces, and the retail stores, it's going to be hard to be conclusive on that.

So, from our perspective, it's very important to derisk the strategy to make sure that you can execute and get listings. That's very, very important to make sure we can capture market share. And also to produce obviously a high-quality product, and that's why we've invested in the machinery that we have and the team that we had and made the partnership with someone like a PAX. But also on the cost side, it's important that we drive economies of scale and that we are focused on a couple of product lines and not and try to be in every single product line out there.

So, vape pens is obviously the biggest component of the Rec 2.0 market and edibles is second, and that's why we're not really chasing beverages. We're not in a hurry to rush to capture what in the U.S. is a very small market. And admittedly it will be a bigger market probably in Canada once it's done a bit better. So, for us that's really focused on execution of both the quality of the product and also the cost in making sure that we can produce at large scale and also be efficient on what we're doing.

Alec Patterson
Head-US Consumer Research, Allianz Global Investors

Q

Okay, great. Thank you.

Operator: David Kideckel with AltaCorp Capital. Your line is open.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Hi. Thanks for taking my second question. I just wanted to go back to the international strategy that you were talking about at the outset of the call. Can you provide any sort of – I know you mentioned, I think, Greg, Germany and the synthetic CBD play. But for the international market, should we be thinking OGI with European partners or LatAm or what part of the world does international move for OGI?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

I mean, as so you've seen to-date, David, we've been focused on Europe. I think that what presents the greatest near-term opportunities for us. We see the European market and why we keep saying CBD is a huge unmet need there is every time I'm in Europe, what you see is kind of an expansion of CBD products across the retail footprint, whether or not that's pharmacy or health and wellness stores and kind of a growing consumer demand there as we're seeing in the U.S. as well.

So that's our primary focus. I mean, we do – we have exported and continue to export product to Australia, but really our kind of market that we're spending the most time evaluating because of the near-term opportunity is Europe, so.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay, thank you. And my last question, back to one of the earlier statements made, I think you have about 700 employees now and by calendar year-end going to 850. Given your vast automation capabilities, I'm just wondering what type of labor are you looking for at OGI to grow this base? Are you looking at R&D-type talent?

Scientific talent or will this be operational in nature? Just any color you can provide with respect to employee and labor as you look forward to the year-end?

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

A

Yeah, I mean, certainly, what we'd expect – I mean, so our labor force needs are not that significant in terms of that group building out. What still needs to grow for us are some of the key supporting areas like quality, that are involved in the testing and quality compliance side of things.

And then R&D as you said, I mean, that group is growing and building for us and we've expanded out the project teams for products like chocolate. I mean we have two individuals that have world-class experience that worked in markets like Belgium and other markets on chocolates. And so we've been expanding those teams as well.

So it's a mix of people, but I think our automation continues to kind of reduce our requirement for labor. So we're able to have – even just last week, I was in Moncton and we have an internal job fair. So, people were looking to move to other departments, so kind of we evolved as a company. And it's great because it's created some new opportunities for internal people to move around as well. So, it's a real positive from a workforce environment.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

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Okay. Thanks very much. That's it for me.

Gregory Engel
Chief Executive Officer and Director, OrganiGram Holdings, Inc.

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Thanks, David.

Operator: This concludes the time we have for today's call. We thank you for your participation. You may now disconnect.