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HEXO Corp. (HEXO.CA)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the HEXO Q3 2020 quarterly call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

Please be advised that today's conference is being recorded. [Operator Instructions]

Thank you. I would now like to hand the conference over to your moderator for today, Jennifer Smith, Director of Investor Relations. Please go ahead.

Jennifer Smith

Director-Investor Relations, HEXO Corp.

Good morning. Thank you all for joining us this morning for our 2020 Q3 earnings call. We will start with a presentation by our CEO, Sébastien St-Louis; followed by a recap of our third quarter results by our CFO, Stephen Burwash, before opening the floor to questions from our financial analysts.

Before we begin, we would like to remind you that today's presentation contains forward-looking statements that involves known and unknown risks and uncertainties and other factors that could cause actual events to differ materially from current expectation. The forward-looking statements are based upon and include the company's current internal estimates, plans, expectations, opinions, forecasts, projections, targets, guidance, or other statements that are not statements of fact.

Any statements contained herein or discussed during today's session that are not statements of historical facts may be deemed to be forward-looking statements. Such statements can often but not always be identified by use of forward-looking terminology and other similar words and expressions that are prediction or indicate future events and future trends, including negative and grammatical variations thereof or statements that certain events or conditions may or will happen or by discussions of strategy.

These statements should not be read as assurances of future performance or results. Such statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements to be materially different from those implied by such statements. Those risks and uncertainties include, but are not limited to: those relating to the company's ability to execute its business plan; renew required permits, licenses, and related regulatory compliance matters; implement its growth strategies; obtain and maintain financing on acceptable terms; maintain and renew required licenses; maintain good business relationships with its customers, distributors and other strategic partners; keep pace with changing consumer preferences; protect intellectual properties; manage and integrate acquisitions; retain key personnel and relating to the company's competitive advantages; the development of new products and product formats for the company's products; changes in laws and regulations; and the absence of materially adverse changes in the industry or global economy.

A more complete discussion of the risks and uncertainties facing the company appear in the company's Annual Information Form and company's Management's Discussion and Analysis for the three- and nine-month period ended April 30, 2020, which are available under the company's profile on SEDAR. Although, the company has based forward-looking statements on the assumptions that it believes are reasonable, it cautions the readers that the actual results and developments, including the company's results of operations, financial conditions, liquidity

and the development of the industry in which the company operates may differ materially from those made or suggested by the forward-looking information contained herein.

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I'll now turn the floor over to Sébastien.

Sébastien St. Louis

Co-founder, Chief Executive Officer & Director, HEXO Corp.

Thank you, Jennifer, and good morning, everybody. I'd like to start by wishing everybody a safe time and good health and to thank and acknowledge the incredible efforts and dedication of our entire team at HEXO as we navigate through this pandemic caused by COVID-19. While the global economy has seen a dramatic reduction in GDP, staggering unemployment numbers, what's encouraging at least in our industry is that we've been stable and even more than stable, we're growing.

Our team has rallied to meet the challenges as presented and actually exceeded expectations. We've continued to introduce new products and we continue to increase our volumes as we gain market share on our competitors. The company has implemented rigorous safety protocols to mitigate the potential exposure and provide as safe a work environment as possible to all our employees.

Our team members have demonstrated incredible results to ensure we continue to execute at the highest levels and achieve operational excellence. We remain vigilant and will continue to proceed with caution.

While we continue to operate during a pandemic, we continue to be cautious about future expectations. Our plans to achieve adjusted EBITDA-positive in the first half of fiscal 2021 or the end of the calendar year will depend on the growth of retail stores in our two largest markets, Ontario and Quebec.

It's difficult to determine the timing of new licenses for new retail stores in Ontario and the build-out of additional stores in Quebec, but we're very encouraged by the huge progress that both our provincial partners have made. With only a limited number of physical stores, the revenue numbers that were published this week by SQDC and OCS demonstrates the tremendous potential of both markets.

SQDC reported sales of 47 tonnes of product and profits of CAD 26 million with less than 50 stores. I want to congratulate SQDC and Jean-François Bergeron on tremendous results, and we're very proud to remain their preferred partner and for our participation in Quebec's success.

On the Ontario side, we're super encouraged by the amazing work that [ph] Cal (00:05:59) and his team have done on analytics in providing the market with detailed market share analysis by product, and we look forward to continuing to see more.

Our industry continues to grow during the pandemic and that's a testament to the consumer demand for safe and legal product offered by licensed producers.

Statistics Canada reported that sales reached CAD 181 million in the month of March, and we're seeing steady demand in the months that have followed. While the March figures only lead to annual run rate of approximately CAD 2.2 billion, most studies have reported that the true market in Canada is closer to CAD 7 billion to CAD 10 billion annually.

There is a great deal of work to be done by licensed producers and governments at each level to safely provide all our products to consumers, the products that consumers are clearly demanding to be able to get to the full potential of this legal market. We need the governments to either continue to build the retail infrastructure or allow the private sector to provide the service the consumer demands. The licensed producers need to lead the way forward by creating and delivering products that compete effectively with the illicit market.

At HEXO, we're determined to be leaders in adult-use market in Canada and other legal markets where we play. Our philosophy is to go a mile deep instead of a mile wide in each market that we participate in and with each product that we launch. With this approach, that led us to negotiate a significant preferred supplier agreement with the province of Quebec, we wanted to be the dominant player and achieve leading market share.

We've done that. We've maintained the market share north of 30% and we continue to provide outstanding service to this prized market. And at this point, with the new success we've had operationally, we're poised to expand nationally and to start to provide that same level of service in other markets.

There's other examples of how this approach of going narrow and deep has led to successful outcomes for HEXO.

We led the way in creating the 28-gram package format and pricing it to compete directly with illicit market. Our competitors have followed suit but we've achieved strong market share with Original Stash. We've been selective in our launch of 2.0 products and our hash product has been an overwhelming success. We've established a dominant position with this product category.

Very pleased to share that our Belleville facility is now fully licensed which includes the Truss beverage facility. This state-of-the-art facility is highly automated. It's ideally located to serve both largest markets in Canada and has a national scale. It has the capacity to grow along with our business and our partners.

The key effect of this facility is it is shifting HEXO to a true manufacturing company, while keeping our roots in agriculture in Gatineau [ph] in Masson (00:08:56). We were one of the first companies to partner with a Fortune 500 company. We created the Truss joint venture, our joint venture with Molson Coors. And this company will launch a series of products from a newly constructed state-of-the-art bottling and canning operation at the Belleville site, and it should lead to being one of the very few players in Canada with significant market share in the cannabis beverage market.

We've also expanded our partnership with Molson Coors with the creation of Truss USA. As per our philosophy, we're going to focus on a first market to dominate in Colorado and to test and learn.

During the later half of 2019, it became clear that the capital market environment for cannabis companies had changed, access to capital was going to be much more restricted. HEXO led the way by being one of the first

companies to rationalize our operations. This was also significantly impacted with the slow rollout of Canadian retail infrastructure, but we adapted very quickly.

We were leaders in the following meaningful ways. We provided exceptional service to the province of Quebec. We moved up the ladder in market share. And as you know, I've often stated our goal is to become a top two player in adult-use market share in Canada. HEXO has moved quarter-over-quarter from a top five spot to now the top four spot nationally.

We've cultivated new high-THC strains that are clearly in demand from the consumer. We have some new HEXO Plus products in the market now achieving 26% THC. We've stabilized and improved our gross margins, being ahead of plan by delivering 40% this quarter. This has allowed us to launch and lead the path in the value segment without our margin deteriorating.

We've reduced cash operating expenses to achieve our internal targets, and we've done all of that in less than 12 months, a big thanks to the team.

We've also created products that utilize all of the components of our cultivation efforts so that inventory does not grow excessively and consume our cash flow. HEXO was making substantial progress towards the trim problem that we all face in this industry. Our inventory impairment has been minimized and we'll continue to monitor go forward.

We have a lot of work to do at HEXO, but the good news is that our revenues are growing, our yields and volumes sold have improved, our gross margin has increased and our costs are coming down. Our adjusted EBITDA loss is under CAD 5 million, and we hope to be EBITDA-positive this year. We've achieved all that while moving up the ladder in market share and taking the top four national adult-use share spot.

With a series of financings we've completed since the end of the last calendar year, our business is on solid financial footing. We look forward to building on those strengths.

Steve, I'll turn it over to you to speak about our financials.

Stephen Burwash

Chief Financial Officer, HEXO Corp.

Thanks very much, Sébastien. Good morning, everybody. As Sébastien mentioned, Q3 demonstrated significant improvement in a number of different ways as we move closer to our goal of becoming adjusted EBITDA-positive.

On the revenue front, revenue from sales in the quarter increased by CAD 7.1 million or 30% to CAD 30.1 million (sic) [CAD 30.9 million] from CAD 23.8 million in Q2. Total revenue from sales in the quarter increased by CAD 15 million or 94% when compared to the third quarter of the previous year.

Net revenue increased to CAD 22.1 million from CAD 17 million in Q2 and from CAD 13 million in Q3 2019. Gross revenue from the adult-use channel was CAD 29.8 million, and that represents an increase of 30% from the previous quarter two sales of CAD 23 million. Gross adult-use sales also increased by 104% when compared to the same period in 2019.

Our value brand, Original Stash, continues to drive our sales which is a little less than half of the – sorry, with 48% increase from the previous quarter. Sales of these products were introduced in the province of Saskatchewan as

our channels continue to grow. The increased sales of Original Stash also contributed to the reduced price per gram before excise tax which fell by 9% to CAD 3.19 from CAD 3.49 during the period.

Newly launched hash in the quarter compromised (sic) [comprised] approximately 19% of overall sales quarter-over-quarter. Similarly, oil extract drops contributed 7% to overall adult-use sales growth.

Adult-use volume sold in the period increased 42% to 9.3 tonnes compared to 6.6 tonnes in Q2. Sales volume in the third quarter of fiscal 2020 increased 238% from the 2.8 tonnes equivalent sold in the same quarter of fiscal 2019.

Cost of sales. Cost of sales for the quarter was CAD 13.4 million compared with CAD 11.3 million in the previous quarter representing an 18% increase. The increase is the result of the increased sales in the period offset by realized benefits of reduced direct and indirect labor.

Some of the factors that contributed to the labor cost decreasing were COVID-19 which allowed for reduced labor inputs to our cost per gram and also activity in our Belleville facility for packaging. The cost of goods sold for the third quarter of last year were CAD 6.6 million, a 100% increase in COGS [ph] trending (00:14:50) with the 94% increase in sales.

Gross margin before fair value adjustments for Q3 2020 was CAD 8.8 million or 40% compared with net revenues from the sale of goods, compared to CAD 5.7 million or 33% in the prior quarter. This increase is due to the reduction in the cost per gram as a result of the decreased packaging and irradiation costs, as well as the improved yields per square foot.

While we expect there to be fluctuations to our quarterly gross margins as we ramp our activities in Belleville and introduce new products over the next few quarters, we view this as a significant indication that we will be able to achieve the long-term sustainable portfolio-wide margins of 40% that we've targeted.

Gross margin after fair value adjustments and impairments was CAD 5.7 million compared with negative CAD 7.9 million in Q2.

Our operating expenses continued to decrease through the quarter to CAD 26.8 million from CAD 281.5 million in Q2. Now remember in Q2 included a large number of nonrecurring expenses that came about as a result of changes in the conditions of the Canadian market. For that reason, we look at our operating expenses in two segments, core and nonrecurring.

For our core operating expenses, we saw a decrease of approximately 9%, CAD 25.7 million in Q3 from CAD 28.1 million in Q2. This is down from our peak amount of CAD 46.9 million in Q4 2019. We've continued to focus on reducing expenses where possible and ensuring that each dollar we spend is put to its best possible use.

G&A decreased to CAD 11.2 million from CAD 14.5 million in Q2 2020 due to reduced consulting and professional fees, IT and insurance costs. Marketing and promotion increased to CAD 2.1 million from CAD 400,000 in Q2. As mentioned last quarter, the Q2 expenses were reduced by the reversal of an over-accrual. The current spending is more in line with future expectations.

Research and development decreased to CAD 1 million from CAD 1.2 million as a result of reduction in head count and consulting fees.

Now a quick look at the nonrecurring expenses we saw. An additional CAD 865,000 in restructuring costs related to the continued rightsizing of the team. We've continued to focus on ensuring that we have our teams properly staffed, with the correct number of people, sharing the workload and are appropriately rewarding those top performers who are helping us to achieve our goals.

We also had a loss on disposal of assets to do with the equipment that has been sold out of our Niagara facility, that number was CAD 3.2 million.

Loss from operations of CAD 21.1 million in Q3 compared to CAD 289.4 million loss in Q2 2020. If we normalize the operating loss and exclude certain non-cash and non-recurring items, this decreased to CAD 20.7 million compared with CAD 23.2 million in the prior quarter. The decrease in loss is primarily related to an increase in gross margin and a decrease in operating expenses.

We remain focused on becoming adjusted EBITDA positive. We are focused on driving revenue as a market leader in the markets we serve and reducing expenses through operational excellence.

Cash position, we ended the quarter with CAD 95.3 million in cash, cash equivalents and short-term investments. Subsequent to the end of the quarter, we closed an additional financing, which added over CAD 50 million to our balance sheet.

After a reassessment of our capital plans, we have reduced our requirements dramatically and expect to incur the majority of expenditures in capital over the next three quarters.

With the reductions, realignment and operational changes we've made, our recent financial raises and a strategic use of our ATM will allow us to fund our Canadian operations. I'll now turn the call back over to Jennifer.

Jennifer Smith

Director-Investor Relations, HEXO Corp.

Thank you, Steve. We will now take questions from our analysts. Due to the large number of analysts joining us today, I would ask you to limit your questions to two at a time. You're welcome to rejoin the queue after that. Thank you.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Aaron Grey with Alliance Global Partners, your line is open.

Aaron Grey
Analyst, Alliance Global Partners Corp.

Q

Hi. Good morning and congrats on the quarter.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Thanks, Aaron. Good morning.

Aaron Grey
Analyst, Alliance Global Partners Corp.

Q

So, I guess my first question would go along with receivable of the license at the Belleville facility and I know that you guys had – you've been waiting for that and those a lot of things that could come along with this. So, just want to get some further color on what you expect in terms of kind of the top-line profile, the shift from more automated packaging and how that can kind of flow through to the top line, the timing of that.

And then also on the top, I know you kind of gave some color in terms of it being dependent on whether or not you can get more brick-and-mortar stores in Ontario and Québec, but how also do you feel like the Belleville facility licensing helps you to expand market share in some other premises outside of the two main ones you have right now? Thank you.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Thanks, Aaron. Super excited about Belleville getting its full licensing now, so fully operational facility, but the first thing, short-term slight negative on gross margin. Remember that now that that's an operating asset that we're going to take an amortization hit, so that will show up next quarter, so expect a little bit of pressure on gross margin.

Now, medium term, what's super exciting is that the efficiency that Belleville is bringing to the table just completely make up for that and more. We've got automated packaging going in, a substantial reduction of labor cum productivity. The COGS are going to continue to go down and that's just on direct cost savings. The most significant thing is touching on the market share increase that you're alluding to, and what Belleville can – what Belleville's going to do there by creating new products. And so with the capacity that we have for Belleville, the single most important impact at HEXO is that it's allowing us to create more 2.0 products, convert more of our trim that's on our balance sheet into sellable products at till sales, which results in more products on the shelf and more diversity for consumers. So, we've already started to see that and looking forward to rolling out the full suite of products over the coming quarters.

Aaron Grey
Analyst, Alliance Global Partners Corp.

Q

All right, great. And looking forward to see those kind of come out and just one kind of my second question just continue on with 2.0 products. Now you do have Belleville rolled out, it could come out with hash, which seems to

be off to a great start. How best to think about those additional 2.0 products coming online and kind of impacting the sales line there and kind of any color you could give in terms of what you're seeing right now in the marketplace from 2.0 products that have come out from some of your peers and competitors? And where you think the opportunity is for HEXO to come in when it comes out with its own products? Thank you.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah. So, well, really happy. I mean, HEXO for years has been first to market with a lot of product categories, right? We recently defined with the 28-gram. We're now being first with a hash offering that's national, so we know those things work so we're doubling down, getting leaner on existing product lines so that we can keep upping the quality.

Our Original Stash product now has better humidity and better THC that we've ever seen in it, and so we're really happy to be able to continue to offer pricing that beats the black market with a better quality.

But now as well with success of hash, we're starting to look at other categories. So, look to us continue to expand on our pre-roll line, our vape line, make sure those work well and perhaps even more importantly celebrating the launch of our beverages with Truss. So, we're super excited that you have received the Truss license, so in the next short while we're going to be coming out to market with a full portfolio of Truss branded products, super exciting ready-to-drink beverages.

We're already in market with some ready-to-drink beverage drops, so our very well drops are available today. They're phenomenal. I mean, you can add a couple drops to any flavored drink and it turns any drink, whatever you prefer, into a cannabis drink and you can customize the formulation. So, those have been a great success as well. So, we're going to double down on those and of course we're keeping a couple surprises for consumers downstream, so you'll have to wait for those.

Aaron Grey
Analyst, Alliance Global Partners Corp.

Q

All right, great. Thanks. I'll hop back in the queue.

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

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

Q

Yeah, thanks. Good morning, everyone. First question is, Sébastien, wondering if you could speak a bit more to what industry and maybe your sales trends are looking like now. There was a lot of noise with the COVID pantry loading in March. Have things now settled back to pre-COVID levels and any color amongst the different provinces would be helpful as well?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, I think what has been, and again, I mean, I commended the OCS on their report. I think more of that will be super useful. I think that gives a great clarity on what's happening in our industry. We continue to grow. Yes, we had a little bit of noise around pantry loading for COVID. I think sales of cannabis just continue to go up. We are in a growth category, there's no doubt in my mind.

Yes, we have to keep working through logistical challenges, but no sign of slowing down here at HEXO. So, quite happy with how we're proceeding. That being said, there's a lot of pricing pressure in the next year as we have a very fierce competition and getting to that top two spot is a very difficult journey while assuring profitability. So, we have a hard task ahead of us, but I'm sure the team will deliver.

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

Q

Got it. Okay, that's helpful. And glad you mentioned the pricing pressure because that was going to be my next question is, we talked about what you anticipate about the Belleville ramp in the near term on the gross margin hit, but I wanted to get your thought on as you think about this competition in the industry especially in value, do you anticipate or do you think you might need to get more competitive on the pricing profile of your Original Stash going forward?

And when you think about potential gross margin volatility at minimum from the Belleville ramp, I mean, are there still levers in your OpEx for you to reduce to achieve that positive EBITDA over the next quarter or two? Thanks.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Thanks, Tamy. Yeah, so Original Stash, really interesting case study I think. We launched Original Stash as a black market killer. It was not launched as a value brand. It was really launched as a way for us to offer consumers something legally controlled, better quality at the same price as what they already pay.

What happened is from a legal market perspective, the positioning and pricing were just so aggressive. I mean, we were 40% better priced than almost all our competitors, so it really forced a shift of the entire legal market down. What I think is going to happen is, you're going to see an ecosystem create around Original Stash with some value products that will come out below Original Stash.

And the reason I'm separating the two, the quality of Original Stash is just phenomenal. The humidity control is bang on, the THC percentages are amongst the highest in the country and so it's a very, very high-quality product.

I think there's definitely room for true value plays below that. HEXO is not in a rush for the race to the bottom in terms of that category, also given that our greenhouse asset is producing such high-quality product. I think we have a lot of opportunity for actually higher quality products. So, you just launched, we've just launched HEXO Plus in Québec. So, that's been a quite a success with 26% THC product, so more care and attention there.

So, I think the whole market is going to shift down. Original Stash is going to take its place as a mid-market, a black market killer with the kind of value bargain-basement, call it, 10% to 15% THC products below that at a better pricing, and I think HEXO still has a ton of opportunity in both growing Original Stash market share and introducing new premium products.

On the OpEx versus COGS question, OpEx is starting to get very lean for what we want to build. Remember that I'm set out over the next 10 years to build a global top player with HEXO. So, that means I need significant executive bench strength and we have that today. We have a phenomenal team. We've added the food, CPG-experienced GMs at every site. And so, those people are critical to the success of the organization. So, a little bit of rounding around the edges on OpEx. But the COGS opportunity and what Belleville is going to deliver is still tremendous, so I'm really not worried about pricing pressure.

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

Q

Got it. Thank you.

Operator: John Zamparo with CIBC, your line is open.

John Zamparo
Analyst, CIBC Capital Markets

Q

Thanks. Good morning. My question is also around the value segment and competition more broadly. So, with net pricing down around CAD 225 a gram this quarter, I'm just wondering, do you think this is a floor for HEXO pricing? I know the prior comment maybe it was more around the industry being into a deep value category. But do you see kind of like-for-like pricing on HEXO products seeing a floor here or do you think there is more room to that to decline, given it does seem that you were early to the category for value but some competitors seem to be chasing that as well?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, John, let them chase. I invite them to chase. I mean, at the end of the day, the consumer will drive pricing and I don't think the consumer has a floor in mind. So, as we continue to achieve efficiencies and the whole industry including HEXO is still in its infancy, now we've done very well. We're one of the lowest cost producers all-in in the whole country and you can see that in our gross margin and reflected in our pricing.

But if you look at what we shipped in the quarter, I mean over 9 tons of product. If you look at our market share by volume, HEXO is a top player. Like forget top four, we're in it. And I won't specify exactly which competitor I'm against, but we're right up there as one of the top players. So, let the price shock settle and you will see HEXO emerge I think in that top two scenario. If we need to continue to use our cost advantage of lower pricing to ensure we stay in that top two spot, we will do so. But I don't think of this thing in terms of our pricing floor because HEXO doesn't need a pricing floor. We still have so much upside on COGS control with our Belleville facility that we will continue to deliver better quality to consumers at better prices for at least in the next few years.

John Zamparo
Analyst, CIBC Capital Markets

Q

Okay, that's helpful. Thanks. And my second question is on the capital contributions required for Truss and for the US JV. I know these are build as being generally capital light. I think it's around $30 million in contributions this year. Just trying to get a sense of how much more is necessary to fund that project at least given your current game plan [ph] and how (00:30:59) can expand in future years. But given what you're trying to do now, how much more do you think you'll have to contribute to the JV?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, we learned so much from Molson Coors and the US [ph] assessor (00:31:12) absolutely phenomenal and approaching a capital light model. So, what's really exciting about what we did in Colorado is we took all the lessons learned from Truss Canada, which had a significant investment, right? You're talking about CAD 90 million, up 42%, which was HEXO; and the balance, which was Molson in Canada to build kind of this world-class asset.

But on the HEXO side, we've been innovating, we've been building a patent portfolio on emulsions, et cetera. We can take all that IP. We're removing it down to Colorado. The regulatory environment in Colorado allows us to use pre-existing Molson Coors assets for distribution and so what's really exciting is we're using installed capacity to be able to distribute in that market. So, capital call is in great shape for now. The strategic plan of Truss and Truss USA is fully funded.

I do expect that as we prove out the Colorado market, we will want to expand further, regulations permitting of course, and making sure we stand on side with FDA as we've done so far. And I expect at that time we'll be presented with more capital deployment opportunities.

John Zamparo
Analyst, CIBC Capital Markets

Q

Okay, understood. Thank you very much.

Operator: Rupesh Parikh with Oppenheimer, your line is open.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my questions. So, just going back to your commentary about hoping to achieve positive adjusted EBITDA in the first half of fiscal 2021, as you look at Ontario and Québec, how many stores are there today and what level do you think you need to see it to get to positive EBITDA?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Rupesh, I think that given our market right now, I mean we have decoupled ourselves a little bit from store openings in terms of being able to push forward. Our positive EBITDA is going to come through incremental market share gains out of the existing stores. So, I mean, I don't think it's fair for me to say we're counting on our provincial partners to open X stores in terms of us to achieve that.

I think we're going to achieve that adjusted EBITDA no matter of the store count. The story obviously gets better if our partners open more stores, which they are doing. So, we'll just keep an eye on that.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay. And then, I guess, just a second follow-up question. So, you look at your portfolio, lot of progress on the value side. So, based on that, are you happy with your portfolio positioning and where you are from an inventory perspective?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

No, I'll be happy when the inventory coming off the line goes right to the tail and gets sold in two weeks and everything is fresh with nothing older than three days. So, no, absolutely not happy.

With that said, the progress we've made has been absolutely fantastic. And as I mentioned, I mean, most of our product on the shelf now is less than a few weeks fresh. So, we're talking a massive improvement from early days of legalization, way better quality for the consumer, so that I'm thrilled with.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Thank you.

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

Graeme Kreindler
Analyst, Eight Capital

Q

Hi. Good morning and thank you for taking my questions here. Sébastien, I wanted to go back and just explore a little deeper your comment about the positioning of Original Stash. I understand your distinction you made between it being a black market buster versus a value segment. But do you think there is a risk of the overall consumer just grouping all of the offerings and that offering has also increased in competition as value and you can potentially see another iteration of what we've seen on some of the mid-grade products where consumers end up just differentiating on price as opposed to brand or no price in terms of dollar percent THC?

So, are you worried at all, to put it in another way, that increased competition on the lower bound of that segment could actually erode Original Stash's position or is the pie of this market going to grow substantially enough where it ends up being a smaller slice but of a much bigger pie? Thank you.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, so it's twofold and there's a bit of a third part to it. So, with Original Stash, the whole market is going to shift down. There's pricing pressure across the board, right? As companies leave efficiencies, our provincial partners are simply remaining very competitive, forcing the best possible product for their consumers at the best price. So, nobody is going to get away with just continuously reducing their cost, but not flowing that through to the consumer. So, that's one piece.

The other piece is, most of the competitors in the country don't have manufacturing assets of the sophistication as what HEXO has at our Belleville facility. So, I don't think that the existing 300 licensed producer system is going to continue going the way it does. It's simply impossible for a small-scale producer with no manufacturing capacity to compete with a company like HEXO. So, I think that will continue to mean meaningful improvement for the consumer.

And the third part of that is as we continue to see yield improvements at our cultivation center because it's not just from a manufacturing perspective we're making progress. As we continue to put out more products, HEXO also has some opportunities in introducing new brands that are positioned at a better value than Original Stash.

So, we're really starting to look at that sector as a total growth opportunity, while seeing Original Stash as growth. But yes, you are entirely right to say that it's what we launched basically define the market. I mean, we had 11 of our competitors following the four to six months after we launched, but HEXO is not new to that. The same thing happened when we did the Elixir a couple years ago and I expect that to be the theme for the coming years. But if I'm always six months ahead of everybody, I think that's going to be good for HEXO.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay, thank you for that. I appreciate the color there. That's helpful. Just as a follow-up to that, could you share with us what the total percentage of Original Stash sales were of the 9.3 tons sold in the quarter and what the specific gross margin on Original Stash sales was?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Original Stash was about half. We'll give you round numbers in terms of volume and in terms of margin. We don't share by product, but I can tell you obviously we're targeting that 40% portfolio. And the great thing this quarter is I don't need even to talk about targeting because we achieved it. So, 40% gross margin across the board.

Graeme Kreindler
Analyst, Eight Capital

Q

Okay, thank you very much for that.

Operator: Scott Fortune with ROTH Capital Partners, your line is open.

Scott Fortune
Analyst, ROTH Capital Partners LLC

Q

Good morning. Thanks for the call. Can you provide a little more color outside Québec and I know you maintained 30% plus market share there. What about the other provinces and gaining market share with your products in the other provinces moving forward here?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, absolutely. So, we're going market by market, right, so we're being selective. So, the idea is not to be the number one player in every single market in Canada. The idea is to assure that we're top two in the markets in which we operate, so we're rolling that out. Obviously staying close to our friends in Ontario. That's a very large market, but also active in the Maritimes and out west. So, we're looking at the major markets. We started to roll out 2.0. Our full portfolio products is being made more and more available. We just appointed a new SVP of Sales, super excited to have them start building up our presence outside of Québec and look forward to building share there.

Scott Fortune
Analyst, ROTH Capital Partners LLC

Q

Okay, and then a follow-on. We know Canada got legalized, the flower, the inventory kind of ramped up from that standpoint, the provinces they're taking a little more cautious approach on the 2.0 product on that standpoint. How are they viewing kind of orders, reorders for 2.0 from that standpoint and then what are kind of the discussions around the potential beverages as you roll that out down the road here?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, our beverage portfolio has just had an absolute resounding success because we're taking that portfolio approach basically going to the distributors and saying we have your one-stop beverage solution, right. You can deal with one or two suppliers, but one of them is going to be HEXO and you can have a complete beverage offering. So, that's really resonating as we're touching north of 80% of consumer occasions with our beverages and so we're not short on orders. So, was very happy to see that full license in Belleville so that we could get

going on ready-to-drink. We have a number of fridges and a lot of retailers as well, so we'll be able to offer cold drinks to consumers. So, that's all part of the HEXO promise of quality.

On the – sorry, first part of your question again?

Scott Fortune
Analyst, ROTH Capital Partners LLC

Q

Just kind of how you're seeing the reordering of 2.0 products. I know there's a conservative [indiscernible] (00:40:44) or inventory too much there. How do we look at kind of acceleration there [indiscernible] (00:40:49)?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, so the reorder. So, really the provinces what they're doing isn't complicated, right? They're reordering what sales at the till, so we put boots on the ground to really understand what the till sales are. We're looking at the velocity rates and we're being very careful to keep the channel lean. Our goal is to get to just-in-time system where something comes up a line gets produced, goes into store. Maximize freshness, maximize quality and reduce cost.

Scott Fortune
Analyst, ROTH Capital Partners LLC

Q

Okay, thanks for the color. Appreciate it.

Operator: Andrew Carter with Stifel, your line is open.

W. Andrew Carter
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hey, thanks. Good morning. I guess I want to ask, given the progress to-date, pretty strong sales growth plus 30%. You got 40% gross margin. You're right, very narrow on EBITDA – on your EBITDA loss and close to breakeven.

What are the main kind of impediments to getting there? I mean in the next quarter – two quarters, Belleville is coming online, that you're getting efficiency there. Do you continue with the rate of sales growth? You got the higher margin products selling online. I'm a little surprised and I know you're off a little bit away from it, but it's still kind of predicated on store growth, but it seems like this will be a pretty achievable target just growing with the market in the next upcoming quarters.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Andrew, the certainty behind HEXO has never been higher, so you're read I think is accurate. We've been focused on reducing variability. And we go forward and to get to mature as an organization, right. We're coming off of a seven-year explosive growth startup and as we put a ton of effort in putting top CPG executives in place, HEXO was really mature of its planning process.

And yes, I agree with you. I think that our plan is more realistic than ever and, obviously, there's still some large caveats like COVID, which is still out there, so we got to be careful with those types of things and plan very

carefully. But we're putting health and safety first, which should mitigate some of that risk. Very confident about the future.

W. Andrew Carter
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Right. And then second question, I think – I believe a previous guidance at the high end had CapEx at CAD 110 million for the year. Is that still the case? And I want to ask given the liquidity situation is much improved, are you going to accelerate any of your capital plans or that's still a very meaningful step down coming next year?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Everything we're doing is driving the revenue, Andrew, so meaningful step down for sure. We're really taking a velocity on CapEx of making sure we get a good return on capital. So, any new incremental project, I'm having the team present a full case and I've told them don't even bother presenting me something that does not have a three-year payback. So, we're targeting two years or better and that's really setting the foundation from a responsible spend and tying into that narrow and deep philosophy that we have at HEXO.

W. Andrew Carter
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks, I'll pass it on.

Operator: Matt Bottomley with Canaccord, your line is open.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Yeah, good morning. Thanks for taking the question. Just wanted to clarify something on sort of the value segment of the market and where HEXO looks to put its efforts in various categories. So, Sébastien, I was wondering if can comment on how does translate your 2.0 offerings? Obviously, a lot of new edibles coming to market. [ph] Base Tens (00:44:07) have been around now since January. So, if you start ramping up some of these products, how do you view pricing or value segment there? It's hard to sell just from looking at some of the provincial websites, but it does seem that a couple of these "value priced edibles," some of them that are priced at a significant haircut to the overall average seem to be gaining the most volumes, which makes sense as well. So, are you going to have a similar philosophy in those products to start or just any sort of indication on what types of pricing points you're going to be focused on in the initial [ph] phase (00:44:40)?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, I'd invite everybody to think a little bit broader than just value and high-end. I think the most critical piece to understand our Original Stash strategy is black market displacement. So, when we think of a CAD 4 gram, for example, in the context of the legal market, that sounds like value. In the context of the illicit market, that's just what people pay. And so for a high-quality gram, that's really the mission of Original Stash. That line extension, you've seen us that take into hash, for example.

Now, we happen to be the only product in hash today on a national scale, which is quite exciting. But we've priced hash – despite the fact we have no legal competitors to speak of, we are delivering value to consumers. We've

priced hash at the black market price. And that's our philosophy surrounding everything we're going to do under the Original Stash flagship.

Now, we'll have some opportunities to do some fully disruptive premium things. So, when we come up with 26% THC flower, for example, that we're slotting into our HEXO Plus brand and – because that's simply THC percentage is that the black market can't deliver to-date, at least from the test we're running. So, there's a lot of opportunity still for premium in these products. Again, when you think ready-to-drink beverages, a lot of opportunities there, but I also want to make sure that in the long term, we're offering consumers beverages that are familiar to them and that are in a segment that's approachable.

So, a few years out, I would love for somebody to be able to pick up a case of Truss powered by HEXO cannabis beverages for a CAD 1 or CAD 2 a can. I think that would be critical. For that to open up though, we need the distribution to evolve where we can sell case quantity to really deliver that value in the 2.0.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Okay. One follow-up just on the beverages. I've heard for most number of producers out there that the government has allocated there's some crazy 5-gram equivalent for 10 milligrams that go into a bottle, which is making it hard for consumers to buy [indiscernible] (00:46:51) one day [indiscernible] (00:46:53). Is that something that is weighing on the potential penetration of these products or is it just sort of noise in the interim?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

No, no, you're right. I mean, that's certainly an impediment right now. And the regulatory work, I mean, remember that Health Canada has been presented with brand new legislation, first to legalize, first to introduce 2.0, introducing and they're right at the intersection of food and cannabis. It's a very complicated offering. So, I think in that context, we have to give them some leash to understand the how to evolve the regulations in the right way.

The regulations today are not where they should be. There are still some inconsistencies in terms of concentration. To your point, if you walk into a store, you might be able to buy five ready-to-drink beverages. That doesn't make a lot of sense if we're looking at a risk-based policy. The total amount of THC in those five drinks would be less than what you could buy in an equivalent extract, for example. So, there's some harmonizing to do while putting public safety first and I think those avenues are available. I think the industry association, I think HEXO have been pushing for those evolutions and I know Health Canada is working hard on doing it, so that will come and it will help the market.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Thanks. And if I can just ask quickly, I know you touched on it, just with respect to capital allocation. So, the CAD 150 million odd [indiscernible] (00:48:18) that you currently have right now, you talked about certain elements that it might be applied to, but can you give sort of maybe a larger view or a [indiscernible] (00:48:26) view of how much of that is earmarked for interim OpEx burn potentially funding Truss, other initiatives you're doing versus what might be considered for, lack of a better term, rainy day money?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah, we're certainly being efficient with our capital, so I don't think the idea is to do any rainy day money. But in terms of specific breakdown, Matt, we're not providing the CapEx-OpEx breakdown at this time.

Matt Bottomley
Analyst, Canaccord Genuity Corp.

Q

Okay, thank you.

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

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Hi, good morning. Congratulations on the quarter. Just a couple of questions here. The first is on Truss. I'm just wondering, Sébastien, if you can just give a little bit of some color with respect to the timing of the rollout and also is your intent here just from a strategic perspective to deploy beverages across Canada all at once? Are you looking more at a phased approach maybe starting with your home province of Québec?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah. So, well, the interesting thing, I mean, Truss, although obviously we're half of the partner there, Truss is its own company with its own management team and so Québec's an incredibly important market for Truss, but they're really looking at this as a national play. With that being said, Truss has been very selective in where it goes for distribution and making sure that it has the right type of distribution deals in place. Obviously, logistics a lot more complicated with ready-to-drink beverages and we're leveraging Molson's experiences there. We do expect to be in most of the nation when we launch and the launch is coming soon. For a specific date, I'll let Scott Cooper, the CEO of Truss take that thunder in the next short while.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Okay, thank you. And also, you made an interesting comment as well during your prepared remarks regarding HEXO really being a manufacturing type of organization, but not forgetting your roots as being in agriculture. I'm just wondering what your thoughts are for the medium to long term. Should we still think of cultivation as being obviously key to really all cannabis companies? And if so, do you think altogether moving forward, is cultivation something that HEXO would likely rid itself them altogether?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Well, so the interesting question, would we get rid of cultivation? I mean, theoretically, if you weren't good at it, yeah, you'd want to jettison that business, but HEXO is one of the best in the country, if not the best. So, in terms of cultivating, we're phenomenal at it, like the quality is great, the cost is best-in-class and we keep improving, right. Like, so, our THC yield I've talked about it, but we're now outputting 26% THC out of the greenhouse. So, a big kudos to my cultivation team. So, in that context, no, I absolutely am not getting rid of cultivation. We're going to keep it because it's a big driver of profitability.

I do think you're on the right track though in thinking of cannabis companies not as a one-size-fits-all. I think you have cultivation companies, I think you have manufacturing companies, I think you have IP companies and that's why it's so important for HEXO to be a top market share leader. And that's why we're so significant to move from

number five to number four and on our way to top two is because we are a full-service offering licensed producer. We have one of the most robust IP portfolios in the space as we're invested in innovation. We're one of the lowest cost producers on the cultivation side and now with the Belleville asset, we're possibly one of three or four companies that have the scale and manufacturing expertise to deliver through manufacturing. So, we're playing in those three segments. Manufacturing will start to take more and more importance as we go forward. And what's really exciting about manufacturing is that it uncouples the value of the company from the value of – or the scale of the cultivation. So, where before all these companies were valued on, okay, you can grow 50 tonnes, for example, so your value was X.

With Belleville and our manufacturing, we can manufacture more products that we can grow. So what ends up happening is as prices continue to grow and as we see other competitors specialize in agriculture and cultivation, if they don't have manufacturing, we'll be able to provide that service for them and then we just created upside revenue potential that's beyond our cultivation ceiling.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Thank you. That's helpful. And if I can just ask one more question going back to Original Stash. I'm just curious, when you mentioned, Sébastien, you do have a high-THC product that will enter the market or might be in the market now. I'm going to assume, just for this question, that we can call it a premium high-THC product. And if so, when you're looking at customer preference here or consumer preference when it comes to Original Stash, it meant to really get rid of illicit market product altogether.

When you introduce now a high-THC product and also calling it HEXO Plus, I think you mentioned, are there any potential issues with the consumer how they're thinking about Original Stash being a HEXO product versus a HEXO Plus high-THC product? And any sort of challenges just for the consumer to kind of integrate with on the one hand Original Stash being kind of a lower-quality-type product compared to a higher-THC product.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah. So a lot to unpack there, Dave, thanks. The HEXO Plus product has a brand promise of a minimum 20% THC. So, we noticed in market that consumers were asking and saying, well, we don't want these broad THC ranges and sometimes we don't really know what we're getting until we have the package in our hand. So, that's why we introduced HEXO Plus. There's not a gram in HEXO Plus that's under 20%. And in fact, most of them are going to be north of 25%, 26% as I've said. But there's a brand promise there.

Now, that comes with a premium pricing scheme. On Original Stash, what you have to compare to is the true quality of illicit market, right? When we look at broad testing of illicit market objective data, illicit product is coming in at 13% or 14% THC. Our Original Stash currently is sitting north of 16%.

So when – it is incorrect to name it lower quality, it is much higher quality than what's available in the black market. And of course, care and control, any humidity, and of course the lack of pesticide. So, you get all of that added value. The challenge is telling that to consumers. Because the illicit market has been telling people for years that they're growing 35% THC product, that is not true. But the consumer does believe it today. So, over time as we educate, I think there's a lot of work for us and our provincial partners to get that message across to consumers. And as we do that, we'll be more and more successful with our branding.

David M. Kideckel
Analyst, AltaCorp Capital, Inc.

Q

Thank you. That's very helpful. That's it for me.

Operator: Douglas Miehm with RBC Capital Markets. Your line is open.

Douglas Miehm
Analyst, RBC Capital Markets

Q

Yeah. Thanks. Good morning. Two questions. Number one, as we look to 2.0 products and the growing importance in the market, can you maybe talk about vape pens. And one of the things, specifically, I'd like you to add in here is, you were really the first – you had first-mover advantage when you thought about value market. Are you thinking of – along the same lines for vape pens or something like that?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Hi, Doug. So – well, first, super excited we've got our disposables out in the market in Alberta. So, we are currently at pilot scale on our vape manufacturing. So, we will, at some point, I'm sure, take in our Belleville facility to do the – to flip the cost on its head and go to the next level. But more importantly, from a quality perspective, our vapes have been extensively tested. No adverse reaction through our clinical trials, so we have actual data. So, we're very confident in putting those in front of consumers. They are made from all-natural ingredients, so there's no extraneous chemicals or anything that might cause those adverse reactions. We're very, very happy. And our innovation team's done a phenomenal job on the flavor profiles.

So, we're getting rave reviews at the moment and we've actually managed to really deliver specific experiences with the mix of flavor – flavor oils and terpenes. So, in our disposables, I mean, for example, our Trainwreck product, that's a disposable vape that's currently in Alberta, is coming back with reviews. People are calling it some of the strongest vapes they've ever tried. And so, we're very, very happy with our quality. Now, the question will be how do we scale that up from a manufacturing perspective.

And so, I think it's a completely different strategy with vape and Original Stash from approach to the market because vape is a much more complex manufactured product. You also have a ton more upside once you automate. So, it's going to be exciting to see that one roll out.

Douglas Miehm
Analyst, RBC Capital Markets

Q

Okay. That makes perfect sense. Second question just has to do with the scaling [ph] up those (00:57:45) to commercial levels on the beverage line. Can you comment on whether or not you're seeing like-for-like consistency or variability, I guess; and if you're experiencing similar issues, too, like perhaps some of your competitors saw as they rolled out when they were launching at scale.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Doug, thanks for that. No, and in fact, and this is why I'm so happy we partnered with Molson Coors because if I had tried to do these beverages on my own, I would have had the same issues as my competitors. The Molson guys are – I mean, they've been doing beverages for 300 years. They came in and they installed a 5-part-per-billion oxygen control system in our system.

So, we have now – we now know, and we've known for a while, that oxidation of cannabinoids is a problem for quality. There's simply – there's next to no oxygen in our system, which is phenomenal for quality and consistency. Our shelf stability is very strong. The flavorings that we're using are very stable. We're very, very pleased with the quality. I think we're leaders of very – we'll need to see in-market how the consumer responds. But certainly, from a production standpoint, the Belleville Truss beverage facility is the most advanced cannabis beverage facility I've seen on the planet.

Douglas Miehm
Analyst, RBC Capital Markets

Q

Okay. Great. Thanks very much, Sébastien.

Operator: Pablo Zuanic with Cantor Fitzgerald. Your line is open.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

Yes, good morning. Look, a couple of questions. How should we think about this huge increase expected by the fall in outdoor cannabis cultivation. Is that going to – it's going to affect the flower category in value or even pre-rolls or is it just something [ph] that go into (00:59:33) oil and extracts mostly? I'm just trying to think how that affects the category different format and particularly value segment for flower or maybe not at all.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

It's been really interesting to take a look at some of the outdoor grow stuff. First, I don't think anyone's figured out how to do it profitably. Like, if you look at the margin profiles of some of the outdoor growers, their gross margin is half of that of HEXO. So, there's some work to do just on the supply chain, that's number one. So, it's not ready to go.

Once it is ready to go, will it have impact the flower market? I don't think so. Consumers don't want outdoor products at really at any price. And you're also going to have a lot of quality issues with that product. So, no, I don't think it's going to significantly impact the flower market.

To your point, how does it come into play with extraction? I think that's something we need to keep a close eye on. Does it displace hemp? And that's why it's so significant for us to be installing massive extraction capacity ourselves at our Belleville facility truly moving to being a manufacturing company.

HEXO is not going to invest in outdoor, we're not taking that risk. But in the case where it's successful, we can become a net buyer of outdoor products, run it through our world-class extraction processes, and then feed our 2.0 offerings. And for us, we'll be agnostic whether we get those cannabinoids from an outdoor cannabis grower, an outdoor hemp grower or a biosynthetic producer down the line. What's important to HEXO is being able to manufacture great products, formulating IP-protected experiences and having consumer market share.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities

Q

All right. And one more. Just remind us what percentage of your sales came from the Quebec Province, if you can disclose that, for the quarter. And also characterize how Quebec performed as a market post the March pantry loading in April, May, even June, compared to other provinces, right? Apparently, there was a restriction, so the

market performed better. But just some more color there in terms of the last three months for Quebec versus rest of the country.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.
A

Yeah. I mean, Quebec is still our primary market. Over 80% of our sales were in Quebec this quarter because we've kept that as our top-top-priority market, but that was also capacity constrained historically. That capacity constraint is largely lifted now. So, you'll see us starting to roll out as I mentioned in other markets, but we're being selective to make sure that if we do go into a market, we want to play in that top two position.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities
Q

Yeah, but can you comment in terms of how the market performed in the last two or three months versus the other market, it sounds like it's been a much stronger market with less restrictions in Ontario and B.C. and other provinces, or that's unnecessarily too, not so different?

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.
A

No, really the margin improvement has come through cost control. So, it's really not...

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities
Q

Sorry, but the market – Sébastien, I'm sorry, not the margin, but I'm talking about the market. What I've heard from other provinces is that because of the stores' shutdowns and restrictions, Quebec has been a market that's been better performing as there's been no major shutdowns compared to other provinces. I'm just trying to understand, seems like [indiscernible] (01:02:44)

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.
A

Yeah, yeah, yeah. [indiscernible] (01:02:45) Sorry. Thank you. Yeah. So, well, Quebec published their numbers, right? So 47 tonnes shipped and then you compare – and I think that's the top market in Canada right now. And, I mean, Ontario has done a phenomenal job as well. They shipped 35 tonnes. But obviously, if you adjust for population, I think Quebec is clearly doing – has made the right choices in terms of getting to the most amount of people.

Pablo Zuanic
Analyst, Cantor Fitzgerald Securities
Q

Right. And one last one, if I may. And I ask this, of course, respectfully, with the two equity offerings in the last two months, plus the bond conversion, the bond conversion, your shareholders, those that held their stock back in February, March were diluted by about 64%, right? That's massive. But maybe that's a cause to raise capital and to survive in this industry, especially with all the opportunities that you have.

But after that, and today in the call you are talking about making use of the ATM in the future, I mean, just – I think that you need to give it more color in terms of how people should think about the further risk of dilution in the months ahead. Can you comment on that a bit more. I mean, you didn't really exactly give the CapEx number, I

think it was CAD 110 million or CAD 150 million, but I'm just trying to feel more comfortable that there's no major dilution coming in the next few months. Thanks. That's it.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Thanks for that. I think what's important, and I've said this for the last seven years, HEXO is set out long term to build a globally dominant cannabis player. Those companies will require, over the long term, billions of dollars of capital. Now, I think we can safely revive that type of thinking because we've learned so much and we're learning how to get a lot more capital light.

So, years ago, I threw out a number, if you wanted to build as one of the top three global cannabis companies, it'll cost you CAD 6 billion. That's the number I threw out. I think the number is lower than that today because I think we've gotten a lot smarter in how we approach and a lot – a more capital light. We've had some international sales now at HEXO that you'll see roll out in the following months. You'll see that show up in our revenue line. We're doing those right from Canada with no assets installed, no employees installed internationally. So, we're getting a lot smarter.

But that in mind, when you look at the global cannabis opportunity, and let me scale it back to even Canada, the top three players in Canada will be splitting a CAD 10 billion market here in the country. Now, our share, the licensed producer's share of that market is going to be CAD 5 billion, right, take out excise tax, take out margin. So, you've got three players splitting a CAD 5 billion market, give CAD 1 billion of that market to other small players, right, the non-majors.

I'm playing to be a major player. If HEXO is successful, we will have a significant share of a CAD 4 billion revenue stream. The dilution needs to be controlled, but the bet and making it to that top three will make that dilution irrelevant because the success will be resounding for long-term holders. Of course, we're in a hyper-volatile market and I certainly wish we would not have had this global pandemic which put us in a position to where, yeah, we raised the terms that were unfavorable.

But you've seen us recover from that, no longer doing unit deals, so you could be rest assured that that's off the table. We now have our ATM launching with unbelievable volumes, so giving us access to capital as needed. And more importantly, we're moving towards that adjusted EBITDA-positive. So there's not an OpEx strain.

I've also talked about our capital prioritization. If we're deploying capital at a 30% to 50% return in the future, the dilutive effect becomes additive, not dilutive. And so, I'm very confident in that strategy. Does that answer your question?

Operator: Our final question comes from the line of John Chu with Desjardins. Your line is open.

John Chu
Analyst, Desjardins Capital Markets

Q

Hi. Just one quick question. So previously, you had mentioned the Belleville facility was that to act as a facilitator to bring on new 500 – or top new partners in the market from a CPG perspectives [audio gap] (01:06:56-01:07:02)...

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Sorry, John, yeah, did you finish your thought? I lost you at CPG perspective.

John Chu
Analyst, Desjardins Capital Markets

Q

Oh, yeah, I'm just curious about how discussions are with new CPG partners now that the Belleville facility is up and running and licensed.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

A

Yeah. Well, we haven't toured them yet, but they're all asking which is super exciting. So, we're still – our conversations are ongoing. Again, those are long-haul conversations and very complex deals. I'm still at the table with major world-class companies and we're still very excited about the potential. We've got now about 400,000 feet of manufacturing space that's in a licensed facility, world-class cannabis center of excellence right next to another Fortune 500, right next to Truss, all in the same building, next to HEXO operations that's available to those Fortune 500 partners.

So, we'll be beginning tours probably sometime in the next couple of months for not only those potential Fortune 500 partners but also other partners, investors, et cetera. So, looking forward to showcase that facility. And, yeah, for sure, I think that's going to have a positive impact in landing some partners.

Operator: There are no further questions at this time. I would now like to turn the call back over to our presenters for final remarks.

Sébastien St. Louis
Co-founder, Chief Executive Officer & Director, HEXO Corp.

Thanks, everybody. That's all we have for today. I'm very excited about the quarter. Thanks again, big thanks to the team, and look forward to talking to everybody in Q4.

Operator: This concludes today's conference call. We thank you for your participation. You may now disconnect.