BCP Research: Aphria Inc (APHACN -/-/-) – Initial Thoughts and 1Q21 Results – Upgrade to 'Positive-Swap'

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Summary: Aphria Inc (Aphria) is a Canadian-based cannabis producer with leading domestic market share (14%) and global aspirations. The company reported 1Q21 (8/20) results showing y/y growth but flat sequential revenue as cannabis operations were dragged down by declines in distribution, negatively impacted by COVID-19. Adj. EBITDA performance was higher y/y and q/q, reaching US$8 mm (7% margin), with continued ramp-up in production driving cost reductions. Heavy working capital drove cash burn of US$48 mm in the quarter. As a result, net debt increased to US$71 mm (v. US$4 mm in 4Q20) and LTM net leverage expanded to 3.6x.

Production was not disclosed in the quarter. We calculate cannabis inventory at over 400 days, which although modestly lower on the quarter, remains elevated and highlights our key concern for the issuer and industry: oversupply. Weak pricing trends are further evidence of the dynamic. Bulls point to eventual expansion of retail locations, slowed by the pandemic, and taking share from the illicit trade, which has failed to materialize of late. We fear oversupply is likely to worsen near-term with the entry of outdoor growers into the market.

We estimate a 1,200 bps credit spread, reflecting high cash burn and industry overcapacity. Our credit spread implies 10% potential upside for APHACN 5.25% 24s from current levels (83c) to fair value (91c) v. 4% downside to the bond floor (79c). US-based peers trade at tighter spreads, supported by robust adj. EBITDA margins (~50%). Consensus expects Aphria revenues to nearly double and reach 24% margins by '23 (BBG estimates), which would support positive FCF and strengthen the credit profile. Based on consensus, we see TEV / 2023 adj. EBITDA at 7.6x v. TEV / LTM 1Q21 adj. EBITDA of 74.1x. We expect cash burn to persist given continued WK demands. If Aphria cut production, we think cash burn could be reduced to manageable levels, given the US$307 mm liquidity position. We await evidence of a more balanced supply/demand industry profile, initiating coverage on APHACN 5.25% 24s with a 'Positive-Swap' rating within our convertible universe, with IVOL on the converts of 27% v. ~80% on 100D and IVOL of listed calls on the common, offering an attractive opportunity for investors looking monetize the volatility differential.

	Amt Out (US$ MM)	Mid Price	Mid YTW	Implied Vol	Cheapness (par)	Delta (par)	Conv. Price	PVG US Price
APHACN 5.25% 06/01/2024	259	82.5	11.29%	27.09%	7.61%	55.69%	$9.38	$4.63

Source: Equity information sourced from Bloomberg. Convertible pricing as of October 20, 2020

Comparable Credits:

US$MM	Aphria	Aurora Cannabis	Tilray	Trulieve Cannabis Corp
Region	Canada/ Int'l	Canada	Canada	US / Canada
Bond Ticker	APHACN	ACBCN	TLRY	TRULCN
Coupon	5.25%	5.50%	5.00%	9.75%
Maturity	6/1/2024	2/28/2024	10/1/2023	6/18/2024
Currency	USD	USD	USD	USD
Amt Out (US$MM)	259	345	475	130
Maturity Type	Convertible	Convertible	Convertible	Fixed
Rank	Sr Unsecured	Sr Unsecured	Sr Unsecured	Secured
Mid Px (10/20/20)	82.5	43.0	41.0	104.7
Mid YTW (10/20/20)	11.29%	36.41%	41.57%	7.76%
Equity Ticker	**APHA US**	**ACB US**	**TLRY US**	**TCNNF US**
Share Px	4.63	4.68	6.64	21.80
Shares Outstanding	289	115	111	58
Market Cap	1,340	541	844	2,807
Minority Interest	32	(18)	-	-
Net Debt	71	376	375	80
TEV	1,442	899	1,219	2,887
Financial and Operating Results (US$MM)	**LTM 1Q21 (1)**	**LTM 4Q20 (1)**	**LTM 2Q20**	**LTM 2Q20**
Net Revenue	**418**	**208**	**200**	**367**
Adj. EBITDA	**19**	**(110)**	**(225)**	**192**
Adj. EBITDA margin	*5%*	*(53%)*	*(113%)*	*52%*
Working Capital	(118)	3	-	(124)
Capex	(82)	(267)	(329)	(68)
Lease Liabilities	(1)	(6)	(96)	(5)
Free Cash Flow (excl. interest and tax paid)	**(181)**	**(379)**	**(650)**	**(5)**

Comparable Credits (continued):

US$MM	Aphria	Aurora Cannabis	Tilray	Trulieve Cannabis Corp
Total Debt	378	500	512	230
Cash	307	125	137	150
Net Debt	**71**	**376**	**375**	**80**
Cash to LTM Revenue	**73%**	**60%**	**69%**	**41%**
Gross Leverage	**19.4x**	**n/a**	**n/a**	**1.2x**
Net Leverage	**3.6x**	**n/a**	**n/a**	**0.4x**
TEV / LTM EBITDA	**74.1x**	**n/a**	**n/a**	**15.0x**
2021 BBG Consensus Estimates (2)				
Revenue	566	267	348	706
EBITDA	76	17	5	315
EBITDA margin	*13%*	*6%*	*1%*	*45%*
TEV / EBITDA	**18.9x**	**54.0x**	**250.7x**	**9.2x**
2022 BBG Consensus Estimates (2)				
Revenue	729	417	501	933
EBITDA	144	69	45	479
EBITDA margin	*20%*	*17%*	*9%*	*51%*
TEV / EBITDA	**10.0x**	**13.0x**	**27.2x**	**6.0x**
2023 BBG Consensus Estimates (2)				
Revenue	795	521	672	1,179
EBITDA	189	109	91	628
EBITDA margin	*24%*	*21%*	*14%*	*53%*
TEV / EBITDA	**7.6x**	**8.2x**	**13.3x**	**4.6x**

(1) APHACN reflects 1Q21 (end Aug '20) reporting period, ACBCN reflects 4Q20 (end June '20)
(2) Based on Calendar Year (end December 31st)
Source: Equity information sourced from Bloomberg. Pricing as of October 20, 2020

Background:

- Aphria Inc (Aphria) is a Canada-based global company, focused primarily on the production and distribution of branded, greenhouse-based quality cannabis products, including single strain flower, for medical and adult use (APHA, Toronto Stock Exchange and Nasdaq)
- Canadian Operations:
    - The majority of Aphria's cultivation, production and distribution is focused in Canada, through subsidiaries:
        - *Aphria One (Leamington, Ontario):* The company's main 1.1 mm square foot greenhouse facility with a production capacity of 110,00 kg of cannabis/year. Wholly-owned and licensed to cultivate, process, distribute and conduct R&D (license expiration: March '23)
        - *Aphria Diamond (Leamington, Ontario):* Secondary greenhouse facility, which was incorporated in November 2017 under a JV with Double Diamond, and of which Aphria is majority (51%) owner. Licensed to cultivate (license expiration: Nov. '20)
        - *Broken Coast (Vancouver, B.C.):* Indoor production facility. Wholly-owned subsidiary, acquired February 2018, and licensed to cultivate, process, distribute and conduct R&D (license expiration: March '23)
        - *Avanti Rx Analytics*: Provides laboratory testing services to Canadian cannabis business. Responsible for exports and processing of production from Canada. Holds (i) Cannabis Processing License; (ii) Cannabis Analytical Testing License; (iii) Drug Establishment License; and (iv) Medical Device Establishment License. Licensed under

Part II EU-GMP certification to process, package, label and/or test cannabis oil, dried cannabis for medicinal use, and bulk dried flower into finished product for sale

- Medical Cannabis Brands: Aprhia and Broken Coast, sold through a direct to patient model using the company's medical portal
- Adult-use Cannabis Brands: RIFF (premium+ brand), Broken Coast (premium brand), Good Supply and Solei (core brands), P'tite Pof (value brand), and B!NGO (lower potency economy brand). Majority of sales function outsourced to Great North Distributors Inc (wholly-owned subs. of Southern Glazer's Wine & Spirits)
- Market Share: The company is the top Licensed Producer (LP) in terms of sales with 14% market share in Canada, and top LP in terms of sales to provincial control boards across all brands in Ontario (17.2% market share) and Alberta (13.4% market share), third largest LP in British Colombia (B.C.) and fourth largest LP in Quebec
  - We highlight anticipated competition with the entrance of recently-approved outdoor growers
- Licensing/Certification: Aphria is based and amalgamated under the laws of the province of Ontario, operating under the legal framework of the Canadian Cannabis Act, which regulates cannabis production, cultivation, export and use in Canada under two-year operating licenses. The company has been licensed to produce, cultivate and sell adult and medical use cannabis and cannabis-derived extracts in Canada since Nov. '14, sell cannabis extracts since Aug. '16, sell to the adult-use market since Oct. '19, and sell derivative cannabis products since Oct. '19.

- Other Operations:
  - Additional operations are located in Germany, Italy, Israel, Malta, Colombia and Argentina
    - *CC Pharma GmbH (Germany)*: wholly owned subsidiary and Aphria's primary hub, historically focused on non-cannabis products, and now in the final phases of launching a cannabis cultivation and production facility, through subsidiary "Aphria Rx", which is expected to be fully operational by November 2020, with first harvest having occurred in 1Q21
  - In addition, Aphria also maintains strategic relationships with Australia, Denmark, Poland and Israel, related primarily to clinical trials and strategic supply agreements
    - 2-year Strategic Supply Agreements established with Canndoc Ltd, subs, of InterCure Ltd., the largest medical cannabis producer in Israel, to exclusively supply 6,000 kg of dried bulk flower, with opportunity for extension
  - Licensing/Certification: Production, processing and distribution of cannabis in Europe is regulated and certified under the European Union Good Manufacturing Practices (EU-GMP), and must be renewed every 3 years. In Germany, specifically, production licensing is obtained via the German Federal Institute for Drugs and Medical Devices (BfArM), and is valid for a period of 5 years, with opportunity for extension following re-evaluation prior to granting renewal.
    - Subsidiaries Avanti, Aprhia One, and ASG Pharma Ltd. (Malta) have all received certification from the EU-GMP in the past 12 months, enabling distribution of medicinal and investigative medicinal products

- Subsidiary, Aphria Rx was recently awarded license for in-country cultivation of medical cannabis, approved by the BfArM, which includes the granting of 5 lots at its cultivation center at Neumunster for medical cannabis cultivation
- Licenses have been granted and acquired in Latin America and the Caribbean as well, with Colombia as a potential hub

1Q21 (8/20) Financial Results:

- Production volumes were not disclosed in 1Q21. However, most recent information shows a wide dislocation between production v. sales, raising concerns about oversupply
    - Management stated it temporarily reduced output at Aphria One, it's higher-cost facility, in June '20, but did not disclose output reductions at Aphria Diamond, it's 51% owned secondary greenhouse, which saw unprecedented production in the quarter
- Additionally, while cannabis inventory days (418) were down 11% q/q, cannabis inventory continued to expand, up 19% q/q at US$110 mm, with the majority, US$76 mm, contributed from cannabis plant (+28% q/q)
    - We note breakdown of harvested v. purchased cannabis plant was also excluded in the quarter, and assume increase in inventory was attributable to higher harvest output in the quarter, with harvested cannabis plant accounting for 90% of cannabis plant inventory historically
- Kilogram equivalent volumes sold totaled 20,882 kg, jumping 250% y/y and 66% q/q
- Cash costs totaled US$0.65 / gram (-40% y/y, +3% q/q), while all-in cost of sales totaled US$1.05 / gram (-45% y/y, -13% q/q)
- Average selling price for medical cannabis (before excise tax) increased 16% q/q to US$5.49 (CAD 7.38), from US$4.74 (CAD 6.63) in 4Q20
- Average selling price for adult-use cannabis (before excise tax) decreased 17% q/q to US$3.09 (CAD 4.15), from US$3.74 (CAD 5.23) in 4Q20, reflecting the initial pipeline fill of new large format offerings, including the introduction of lower-potency economy brand B!NGO late in the quarter

APHACN (US$MM)	1Q21	4Q20	3Q20	2Q20	1Q20	y/y	q/q
Kilograms produced, net	**n/a**	**52,243**	**31,086**	**13,866**	**10,581**	**-**	**-**
Kilograms equivalent sold	**20,882**	**12,567**	**14,014**	**7,062**	**5,969**	**250%**	**66%**
Cannabis	76	59	33	17	12	549%	28%
- Harvested Cannabis	*n/a*	*53*	*23*	*13*	*12*	-	-
- Purchased Cannabis	*n/a*	*6*	*10*	*4*	-	-	-
Cannabis trim	5	3	7	3	2	124%	73%
Cannabis oil	25	22	22	16	12	108%	11%
Purchased CBD distillate	-	4	6	-	-	-	-
Softgel capsules	0	0	0	0	0	(64%)	(72%)
Cannabis vapes	5	4	1	-	-	-	21%
Cannabis Inventory	**110**	**93**	**68**	**36**	**26**	**324%**	**19%**
Cannabis Inventory	110	93	68	36	26	324%	19%
Cannabis COGS	24	18	24	11	12	103%	33%
Cannabis Inventory Days	**418**	**467**	**253**	**296**	**200**	**108%**	**(11%)**
Avg. Retail Selling Price - Medical Cannabis	5.49	4.74	4.87	6.17	5.72	(4%)	16%
Av. Retail Selling Price - Adult-Use Cannabis	3.09	3.74	4.15	3.95	4.56	(32%)	(17%)
Cash cost (USD / gram)	0.65	0.63	0.71	0.84	1.08	(40%)	3%
All-in cost of sales (USD / gram)	1.05	1.21	1.28	1.50	1.91	(45%)	(13%)

- Net revenues were US$108 mm, up 14% y/y and stable q/q, with y/y driven by an increase in volumes sold, and q/q impacted by lower distribution revenue
    - Cannabis revenues increased 103% y/y and 25% q/q to US$47 mm. Cannabis revenues include revenue from cannabis, insurance and excise taxes, and represent 44% of total net revenues
    - Distribution revenue declined 15% y/y and 14% q/q to US$61 mm, negatively impacted by COVID-19, which resulted in reduced numbers of elective procedures and in-person doctors visits, and is expected to continue
- Adjusted EBITDA was US$8 mm, up 865% y/y and 24% q/q, and marking Aphria's 6th consecutive quarter of positive adj. EBITDA generation. Margins remained thin at 7%, though showed steady improvement y/y (+615 bps) and q/q (+135 bps)
    - Cannabis operations reported US$8 mm in adjusted EBITDA (+681 % y/y, +17% q/q) at 17% margins
    - Distribution operations reported US$2 mm in adjusted EBITDA (-39% y/y, +30% q/q) at 3% margins
    - Meanwhile, business under development reported negative US$2 mm in adjusted EBITDA

APHACN (US$MM)	1Q21	4Q20	3Q20	2Q20	1Q20	y/y	q/q
Net Revenue	**108**	**109**	**110**	**91**	**95**	14%	(0%)
Adjusted EBITDA	**8**	**6**	**4**	**1**	**1**	865%	24%
Adjusted EBITDA margin	*7%*	*6%*	*4%*	*2%*	*1%*	*615bps*	*135bps*
Cannabis Revenue	47	38	43	26	23	103%	25%
Cannabis Gross profit	23	20	18	15	12	102%	17%
Cannabis gross margin	***50%***	***53%***	***43%***	***57%***	***50%***	***(14bps)***	***(325bps)***
Cannabis Adj. EBITDA	8	7	5	3	1	681%	17%
Cannabis Adj. EBITDA margin	***17%***	***18%***	***11%***	***10%***	***4%***	***1,230bps***	***(103bps)***
Distribution Revenue	61	71	67	65	72	(15%)	(14%)
Distribution Gross profit	9	9	9	8	9	(5%)	3%
Distribution gross margin	***14%***	***12%***	***13%***	***13%***	***13%***	***154bps***	***231bps***
Distribution Adj. EBITDA	2	1	2	2	3	(39%)	30%
Distribution EBITDA margin	***3%***	***2%***	***3%***	***2%***	***4%***	***(118bps)***	***99bps***

- Cash burn of US$48 mm worsened q/q, attributable to working capital and capex, including several one-time items
    - Working capital use was US$43 mm v. US$9 mm in the prior quarter, and was driven primarily by:
        - Increased A/R (US$20 mm), mainly on the introduction of large format and Bingo pipeline fill late in the quarter
        - Increased inventory, net of FV adjustments (US$15 mm), reflecting lower than anticipated revenues in the distribution business, alongside cash costs placed into inventory for the cannabis business
        - Decreased A/P and accrued liabilities (US$13 mm), balanced by increased income taxes payable (US$11 mm)
    - Capex of US$13 mm was 36% lower q/q, with the majority invested in the new German cultivation facility
- Cash (cash and equivalents + marketable securities) decreased 15% q/q to US$307 mm (73% cash to LTM revenue) on cash burn and one-time items including:

- A US$14 mm f/x impact tied to the US/CAD exchange rate
- Cash payment of US$11 mm related to a legal settlement and subsequent return of a cash deposit to a former customer, reflected in changes in A/P in the quarter
- Delayed receipt of US$14mm in Harmonized Sales Tax (HST) refunds, which have been subsequently received post-1Q21

- Liquidity (cash + A/R) totaled US$370 mm (-8% q/q) at liquidity to LTM revenue of 88%
- Gross debt increased to US$378 mm (+3% q/q), reflecting an increase in short-term bank debt and f/x fluctuation
- Net debt increased to US$71 mm, following cash burn in the quarter, and resulting in LTM net leverage expansion to 3.6x
- Guidance:
    - Working capital requirements are expected to be lower post-1Q21, following the launch of B!NGO and purchase adjustments
    - Capex is expected to reduce to US$6-10 mm in 2Q21, with the completion of Aphria's Germany expansion
    - Management anticipates free cash flow generation by 3Q21 - which may be challenging, in our view, if current production levels are maintained

APHACN (US$MM)	1Q21	4Q20	3Q20	2Q20	1Q20	y/y	q/q
Net Revenue	**108**	**109**	**110**	**91**	**95**	14%	(0%)
Adjusted EBITDA	**8**	**6**	**4**	**1**	**1**	865%	24%
Adjusted EBITDA margin	*7%*	*6%*	*4%*	*2%*	*1%*	*615bps*	*135bps*
Interest Paid	n/a	n/a	n/a	n/a	n/a	-	-
Taxes Paid	n/a	n/a	n/a	n/a	n/a	-	-
Working Capital	(43)	(9)	(38)	(28)	(12)	257%	391%
Capex	(13)	(20)	(29)	(20)	(56)	(77%)	(36%)
Lease Liability Payments	(0)	(0)	(0)	(0)	(0)	-	(49%)
Free Cash Flow	**(48)**	**(23)**	**(63)**	**(47)**	**(67)**	**(28%)**	**111%**
Cash and Cash Equivalents	307	361	384	375	337	(9%)	(15%)
Marketable Securities	-	-	-	-	11	-	-
Cash	**307**	**361**	**384**	**375**	**349**	**(12%)**	**(15%)**
Accounts Receivable	63	40	59	46	36	78%	56%
Liquidity	**370**	**401**	**443**	**420**	**384**	**(4%)**	**(8%)**
ST Bank Debt	6	0	5	2	-	-	-
ST Lease Liabilities	1	1	1	1	1	21%	3%
ST Debt, Other	8	6	5	5	5	76%	35%
LT Lease Liabilities	4	4	4	4	4	11%	4%
LT Debt, Other	99	94	97	100	41	142%	5%
Convertible Debentures (1)	259	259	350	350	350	(26%)	0%
Total Debt	**378**	**365**	**462**	**461**	**400**	**(6%)**	**3%**
Net Debt	**71**	**4**	**78**	**86**	**51**	**38%**	**1,586%**
LTM Net Revenue	**418**	**405**	**392**	**338**	**263**	**59%**	**3%**
LTM Adj. EBITDA	**19**	**13**	**7**	**(8)**	**(17)**	**(213%)**	**53%**
LTM Gross Leverage	**19.4x**	**28.8x**	**68.6x**	**n/a**	**n/a**	**n/a**	**(9.4x)**
LTM Net Leverage	**3.6x**	**0.3x**	**11.6x**	**n/a**	**n/a**	**n/a**	**3.3x**
Cash to LTM Revenue	**73%**	**89%**	**98%**	**111%**	**133%**	***(5,923bps)***	***(1,575bps)***
Liquidity to LTM Revenue	**88%**	**99%**	**113%**	**124%**	**146%**	***(5,759bps)***	***(1,061bps)***

(1) Convertible debt valued at par

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"Market Perform" – The bond's total return is expected to be in line with the total return of the CEMBI Broad Diversified High-Yield Index over the next 3 – 6 months.

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“Not Rated” or no comment – Currently, the analyst does not have adequate conviction about the bond’s total return relative to the CEMBI Broad Diversified High-Yield Index over the next 3 – 6 months.

Quasi Sovereign Universe
“Market Overweight” – The spread of the bond to its similarly duration sovereign controller bond is expected to decrease over the next 3 – 6 months.

“Market Weight” – The spread of the bond to its similarly duration sovereign controller bond is expected to remain unchanged over the next 3 – 6 months.

“Market Underweight” – The spread of the bond to its similarly duration sovereign controller bond is expected to increase over the next 3 – 6 months.

“Not Rated” or no comment – Currently, the analyst does not have adequate conviction about the bond’s spread to its similarly duration sovereign controller bond over the next 3 – 6 months.

High Octane Universe
“Speculative Buy” – Bonds that in our view have an equity investment risk profile and we think risk/return is significantly skewed to the upside

“Positive” – Bonds that in our view have an equity investment risk profile and we think risk/return is skewed to the upside

“Neutral” – Bonds that in our view have an equity investment risk profile and we think risk/return is balanced

“Negative” – Bonds that in our view have an equity investment risk profile and we think risk/return is skewed to the downside

“Speculative Sell” – Bonds that in our view have an equity investment risk profile and we think risk/return is significantly skewed to the downside

Convertible Universe
“Outright” – Convertible bonds that, in our view, present risk/return significantly skewed to the upside (3x upside v. 1x downside)

“Swap” – Convertible bonds that, in our view, offer attractive volatility differential between implied volatility of the convertible bond option call v. the 100D realized volatility and listed calls in the option market for the corresponding equity

“Busted” – Convertible bonds trading with out-of-the-money option calls that, in our view, offer an attractive yield to maturity, relative to risk/return

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