Cannex Capital Holdings Inc. and 4Front Holdings, LLC

Transformational Business Combination Conference Call

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PRESENTATION

Operator:

Greetings, and welcome to the Cannex Capital and 4Front Holdings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Anthony Dutton, CEO of Cannex. Thank you. You may begin.

Anthony Dutton:

Thanks very much and good morning, everyone. Thank you for joining this morning's call to hear more about our proposed business combination with 4Front.

Before I begin, I'm obligated to remind everyone that during the course of this conference call, management may be making some forward-looking statements, which forward-looking statements are based on current expectations that are subject to a number of risks and uncertainties that may cause actual results to differ materially from expectations. These risks are outlined in the Risk Factors section of our filings and our disclosure material. Any forward-looking statements should be considered in light of these factors. Please also note, as Safe Harbor, any outlook we present is as of today, and management does not undertake any obligation to revise any forward-looking statements in the future.

Good morning again. My name is Anthony Dutton, CEO of Cannex, and I'm joined this morning by Josh Rosen, the CEO of 4Front. The format of our call this morning is going to be pretty straightforward. I'd like to provide some background and context on both Cannex and our decision to join forces with 4Front. I'll then introduce Josh, who will provide some more detail and color, and discuss in more detail, as well, our joint strategy going forward, post-closing of the transaction, and after a short wrap-up, we will then open the lines for questions.

With the Cannex introduction, I think many people on this call know who we are, but for those that don't, I thought I'd just give a very high level overview of who Cannex is today. Currently, we are obviously a Canadian public Company, and we own and operate, through a series of holding companies, the assets of the largest cultivator/processor in Washington State. We have 120,000 square feet of cultivation facilities, with 60,000 square feet of flowering canopy. We have 40,000 square feet of extraction, processing, and manufacturing, which includes multiple extraction and processing facilities, three industrial kitchens, a very significant footprint in the state. We distribute to approximately 70% to 75% of the dispensaries in Washington, and there are currently around 500 dispensaries in the state.

We are an operational and brand leader in the State of Washington, leading on both the flowering brands and on edibles, and we're profitable, which is pretty unique in this business, I think, for many people on this call who know the sector. Last quarter, we reported net income of $2.4 million for the quarter. In that particular context, again, we think we're a very unique and strongly focused operational Company.

We've developed a set of skills, SOPs, protocols and brands that we see can be really transferred or plugged into any jurisdiction, and what I mean by that is another state, another country, anywhere. Those skills and SOPs are very transferrable.

Our thesis has remained the same since we went public earlier this year. We thought 2018 as a year of what we call kind of early-stage valuations shifting, very volatile, lots of interesting dynamics at play. We think 2019 is going to be the year that the market really starts to pay more attention to fundamentals. Operations are going to matter, understanding how to run a business is going to matter, and simply having a portfolio of interesting opportunities is going to be important, but ultimately, you have to demonstrate that you know how to take those opportunities and turn them into real businesses. Everything that we think about, everything that we look at, we very much look at through an operational perspective.

Our vision, again, going back to our public listing earlier this year, which was in March of this year, was to become a multi-state operator, was to focus on extraction, processing, distribution and retail. Cultivation is important, obviously, but we still think that the middle section of the value chain, if you will, the operations around processing and extraction are key, distribution is key, retail is very, very important, and, ultimately, brands are going to dominate. Another part of our vision is to make sure that we're working with likeminded people, that we've got management alignment, management buy-in, and that we've got some very strong programs from within to train the future managers going forward as we expand our Company.

With that vision in mind, what options did Cannex have to put that plan into motion? Number one, one of the options could have been small, incremental acquisitions with the associated small financings. We thought that was really doable, but at the same time we thought it was going to be a lot of work constantly in kind of M&A and financing mode, and we didn't see that as being the best option. The second option could have been to be absorbed by a larger entity and just become a part of a larger MSO's overall platform. The third strategy that we kicked around a lot was to partner with a likeminded group, a similarly sized group, that had what we call complementary skills across the value chain and, obviously, a similar vision.

From our perspective, in terms of creating long-term, sustainable shareholder value, it was overwhelming, from Cannex's perspective, that number three was the best option, to partner with a group like 4Front, and, ultimately, began to reach out and meet a variety of different groups. We obviously did meet 4Front and it was clear, I think, from both sides—I'll let Josh speak to his perspective, but as soon as we met 4Front, it was crystal clear in our minds that they were absolutely the best group to be working with. They complemented what we have in terms of downstream operational skills, they're the best at licensing, the best at government relations and the best at U.S.-focused biz dev that we've seen anywhere. They're certainly the best at the retail end of the value chain, with a fantastic existing footprint and a huge pipeline for 2019. With Josh and Andrew coming out of the capital markets, Josh from Credit Suisse, Andrew from Blackstone, they certainly have the capital markets understanding sewn up, some phenomenal relationships there. They have a very, very good, as I said, internal scene. They have great management training programs, and really take that part of the business very seriously, which is something that we don't see a lot of companies doing, to be quite frank. They were also, in our mind, at seven times 2019 EBITDA, certainly the best value out there.

With all of those things, including the optionality of the new states, new license and the key relationships, we thought this was absolutely a phenomenal opportunity for us to accelerate both of our business plans, and it really combines talents, combines expertise, and goes across the value chain, as I said, from cultivation right through to retail, got an unrivalled combination of relationships both within the Company and within the industry. Really, what we are doing here is kind of leapfrogging over our earlier two options and moving into, essentially, a ready-made, prepared MSO platform with operational expertise, strategic vision and skill sets right through from cultivation, processing, and into retail.

With that introduction, I'd like to hand it over to Josh, who's going to talk more about who is 4Front and their solid, solid skills, and our business plan and strategy going forward. Josh, with that, over to you.

Josh Rosen:

Thank you, Anthony. As you know, I've already enjoyed working with you and your team to get to this point, and while our 4Front stakeholders know me to be fairly measured, maybe to a fault in some cases, I'm super excited about this combination. This excitement comes from what I've seen in the industry over the past several years and my confidence that we have a truly unique platform and opportunity to combine the benefits of what is now referred to, as you did, Anthony, a multi-state operator, or MSO, with the honed operating capabilities from one of the most mature and importantly competitive cannabis markets in the world, with 4Front's origins tying back to the Northern California dispensaries scene, back to 2010, 2011, and then Cannex's capabilities, obviously, tied back to one of the most cost-competitive markets in the Pacific Northwest. We're a firm that's been around the block, and I've really not seen anybody with this combination, despite what you hear.

We first met Leo Gontmakher, Cannex's COO, about two years ago, toured the Northwest Cannabis Solutions operation before Cannex existed. We had tremendous respect for the scale and efficiency of what he had back then, and frankly, it's only gotten better.

I'm going to cover five key points: first, I'm going to provide a quick overview on 4Front and our stand-alone plans as they were before this; second, I'm going to describe this fit through 4Front's lens; third, I want to outline some immediate benefits from this plan combination; fourth, I'll highlight the longer term benefits of the plan combination; and then fifth, what many ask for, I'm going to frame this combination with some numbers.

Turning to 4Front as a standalone first. Our President, Kris Krane and I founded 4Front in 2011, and we started as a regulatory and retail operations consulting firm. Kris had been working with Steve DeAngelo of Harborside in Oakland, and a collection of other leading, largely Bay Area dispensary operations, to develop and apply best practices in that dispensary environment. After forming 4Front, we acquired the intellectual property and basically the standard operating procedures and the bones of a management training program from that group, and also brought along some talent, even retaining Steve in the early days as a consultant for the first few years. We applied this team and the intellectual property with great success in winning new licenses in new jurisdictions. In the early days, this was Massachusetts, Nevada, Illinois, and Maryland, as those programs were getting started, and this is how we developed our early credibility, and then we also helped a number of retail operations get opened in these markets. That's our heritage, and these retail and state regulatory competencies remain the pillars of how we approach the industry.

In 2015, we evolved to pursuing our own control and management of operating licenses. Our existing assets on this front can be found in materials elsewhere and include opened operations in four states currently, with more in the pipeline, and we believe we're in very exciting states, in particular, Massachusetts and Illinois. We also anticipate being in a number of additional states as we get through and hit the end of 2019, which I'll cover in a little bit.

Like many others, we've been working toward our own RTO and, for some perspective on standalone 4Front, we'll likely exit 2018 with monthly revenue of around $1.25 million, or $15 million annualized, and prior to this announcement, we were projecting that to increase to approximately $75 million in revenue in 2019, with EBITDA in the $10 million to $15 million range, based only on the existing licenses in our portfolio. We completed a pre-RTO private placement a few months ago and raised approximately $31 million, which increased our total capital raise to approximately $66 million. Up until this last round, it had been mostly done with friends and family. This last round was more than twice the amount we were targeting and happened in a fraction of the time than our previous raises. Our post-money valuation for the last round was approximately $160 million, and we have been having conversations with bankers about pricing our subscription receipts offering in the valuation range of $280 million to $320 million.

I'm a recovering Wall Street stock analyst, spending much of my early career at Credit Suisse, and one of the things that 4Front stakeholders know is I think there's a lot of speculation in near-term revenue and EBITDA projections in this industry, particularly as new regulatory environments first come online. Look no further than the news around Massachusetts this week, turning recreational, to see how non-linear these markets can be. I prefer to frame the larger opportunity in front of us and then focus our team, and then investors, on what we need to execute on near-term to capture our intermediate and longer term goals. I'm going to cover a little bit more ground on the numbers coming up.

Turning to the second point, the fit for this combination with Cannex. The respective capabilities of this combination jump off the page at me and are fairly straightforward. With 4Front's multi-state regulatory and M&A capabilities, and focus on retail, matched with what believe is the best indoor cultivation and production capabilities at scale in the industry at Cannex—4Front investors have heard me say we're playing the game of Risk instead of the game of Monopoly, and this combination exemplifies it, as we believe execution is as important as geography when it comes to building a company that we intend to be a clear market leader in the next two to five years. I sincerely don't think our industry understands just how impressive an operation the Cannex Leadership Team has built, as the focus is often on just how challenging the Washington State market remains. We couldn't be more excited to apply these strong operating efficiencies into much less price-competitive markets.

For some simple perspective on this, Cannex's strategic operating tenants, Northwest Cannabis Solutions and 7Point, harvested just south of 5,000 kilos in the three months ended September. That was in line with Aurora and Tilray. Now, Northwest doesn't get nearly the price point for their product, but frankly, the ability to drive profitability in a market with wholesale pricing below $2a gram is remarkable when mixed with the breadth of product manufacturing and efficiency around packaging and distribution. And we believe the Cannex capabilities will translate into clear competitive advantages in our existing and new markets, which leads me right to the third point of immediate benefits.

4Front has taken a measured approach to our own cultivation and production assets, leaving significant capacity and opportunity for partnership with the type of capabilities Cannex brings to the table. Two immediate opportunities stand out, in particular.

We have a grow/process facility in Georgetown, Massachusetts, which is in the Boston Metro Area. We believe we are within months of getting this through the approvals for recreational. Massachusetts is going to be an exciting market for the next few years, with the first two recreational stores doing a combined $2.2 million in sales in the first five days, according to the data. Our facility has approximately 9,000 square feet of space dedicated to flower canopy currently, but the building has 109,000 square feet in total available space, which allows us to quadruple canopy space and, with the efficiencies from Cannex, well more than quadruple output.

We also have an equally underutilization cultivation facility in Illinois, where we anticipate recreational to pass sometime in 2019, with likely implementation in 2020. Illinois has 13 million people and currently only 19 grow/process licenses. Our operation is in a 94,000 square foot facility, and we've only built out 11,000—a little over 11,000 square feet of it.

We simply can't wait to get Cannex's COO, Leo, and his team activated, aggressively developing these assets. The benefit of having more mature operations in Washington is also that there's a strong hunger on the Cannex team, as well as bandwidth, to demonstrate their capabilities elsewhere.

Looking past these immediate, very tangible benefits, the fourth point I want to cover is the longer term benefits. I've referenced building a company that is a market leader and the importance we place on execution. Having the confidence in our capabilities across the value chain that this combination gives us significantly expands the scope of our business development activities. 4Front has acquired a number of our legacy consulting clients, most recently the one that developed the Massachusetts process facility that I just referenced, and we continue to have a robust pipeline of activities; most notably, in Michigan, Pennsylvania, Nevada, and Arizona.

With what I like to refer to as our regulatory crystal ball, led by Kris Krane, we prioritize states with solid near-term commercial opportunities, as well as looking at fatigued or distressed operators, often with that distress stemming from some type of partnership disagreement of some sort. An example where this planned combination enhances our ability to capture an opportunity, we've been looking at a license acquisition in Arizona, which, by law, are able to be vertically integrated. Only in this case, they only have retail open. We view it as a moderately expensive acquisition as a retail acquisition, but when you add the ability to add a processing facility at scale in a market that has a significant amount of new cultivation capacity coming online, the acquisition opportunity gets much more exciting immediately. This is one of the more speculative acquisition targets for us, but it best exemplifies our enhanced business development lens. As we bring more of these types of opportunities onto our platform that prioritizes operational integrity, we gain more confidence in our ability to capture the blue-sky opportunities this emerging industry affords. This leads me to the last point, framing this combination with numbers.

As I said earlier, we internally focus much less on 2019 and 2020 revenue and EBITDA and much more on what we think our assets and opportunities should generate over the next few years, recognizing the specific timing is very challenging, while the market opportunities are actually not nearly as challenging to quantify, in our opinion. It's the larger opportunities that brought us into this industry, and we think it's the larger opportunities that have investors interested in the industry. Along these lines, I want to outline three scenarios for you, and these are inclusive of Cannex, with the disclaimer that we still have a lot of work to do in terms of optimizing facility design and modeling out the better productivity that we would expect with Cannex. So, no formal projections coming.

The first scenario here is looking at our existing assets. This includes the assets that are under development, so not just what's open, but what we have under development and control. This includes 14 dispensary locations and six grow/process facilities. We frame these existing assets as capable of generating a range of $250 million to $300 million of revenue and $65 million to $75 million of EBITDA, with reasonable expectations attached in terms of market growth.

The second scenario I'd classify as including the near-term M&A and licensing opportunities that we have a high degree of confidence in closing; most notably, adding Michigan and California, where we have properties identified and are comfortable with the licensing requirements. With these included, we think these assets are capable of generating $400 million to $450 million of revenue and approximately $100 million to $115 million of EBITDA.

Last, the scenario that includes our full current pipeline of activity with greater amounts of speculation related to securing licenses and the development of these markets. In this case, adding in a grow/process in Pennsylvania, New Jersey operations, Arkansas and Ohio processing, we think these assets could generate $650 million to $700 million in revenue and $160 million to $200 million in EBITDA.

We obviously see a tremendous opportunity in front of us, and admittedly, as I say these numbers, I'm thinking about all the people we need to hire, the team we have to have motivated, and on and on, but it's truly what gets me up every day, and, as the 4Front team knows, I get up really early every day.

With that, I'll hand this back to Anthony, and I look forward to interacting with number of the Cannex shareholders over the coming months. As noted at the outset, we think this combination is truly differentiated in the marketplace, and while we're in this group of companies being referred to as multi-state operators, my hope is that when the dust starts to settle a few years out, the broader market simply refers to us as a damn good operator and a great Company. We recognize the work that it'll take to get there at the scale that we're after.

Anthony Dutton:

Josh, that was fantastic, thanks very, very much. We'll open the floor to questions very, very quickly. I just wanted to leave you with a few takeaways here, which I think both Josh and I have already touched on, which, as a combined platform, we go right across the value chain, with core competencies and great skills in every element of it. We've got a big footprint. We're now obviously in multiple states, with more in the pipeline. We could easily be in 10 to 15 states once these pipelines come through. Very important to appreciate, as well, that we have a very strong balance sheet, that we've got a funded infrastructure which is already ready to go.

One thing I do really want to acknowledge on this call, as well. We recently, as people who have been following our news flow know, welcomed Gotham Green as a strategic financial partner in the last few days, and they are a phenomenal group to work with, support this transaction, support Cannex, and are going to be a great group to work with going forward, and we're very, very pleased to have them as a part of our capital structure going forward.

I think, as Josh has said, the best is yet to come. We are going to be known as a damn fine Company, I think, to quote him, probably immediately, but certainly in the longer term. With that, I'd like to open up the lines for any questions that people have for either Josh or myself.

Operator:

Thank you. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up the handset before pressing the star key.

Our first question is from Doug Cooper with Beacon Securities. Please proceed with your question.

Doug Cooper:

Hi, good morning, guys, and thanks for the great summary, that is very illuminating. First question, I just want to confirm the capital structure post the transaction. One share Cannex, the 4Front shareholders get 1.75. On a basic share count, that gets me just over 500 million shares, and maybe inclusive of the recent Gotham piece on a fully diluted basis, including their convertible, or the debenture, gets me upwards of maybe 580 million to 600 million fully diluted; is that the ballpark?

Josh Rosen:

Anthony, do you want me, the recovering financial analyst, to take this one?

Anthony Dutton:

Yes, why don't you.

Josh Rosen:

The simple answer is, first, the basis for the exchange, that 1.75, we worked with the assumption of a Cannex Canadian stock price of $1.125 and ran a fully diluted calculation from that number, the only piece, I would say, that's exclusive of the Gotham Green financing, and that would be, as you outlined, incremental shares out—or at least potential dilutive shares down the road, depending on how the stock price performs, obviously. So, you end up with what I'd call just slightly more shares out for the base when you do the 1.75 multiplier as opposed to just over 185 million shares using that as a fully diluted basic—or fully diluted calculation. So, I think your math, generally speaking, was pretty much spot on, save a little precision.

Doug Cooper:

Okay, and the 4Front, just to confirm, the Gotham piece, they would get the multiplier on that piece, as well, or will that just convert into Cannex shares?

Josh Rosen:

I don't think I understand the question. Can you ask that one more time?

Anthony Dutton:

Doug, that would just convert to Cannex shares.

Doug Cooper:

Okay. So, I wouldn't multiply the 29 million shares due to Gotham on the conversion, the 4Front guys wouldn't get 1.75 of that?

Anthony Dutton:

No, and then on top of your fully diluted, you've got the Cannex warrants, you've got the Gotham warrants, which bring a considerable amount of cash with them, as well.

Doug Cooper:

Great, okay, that's great. Just on the numbers, obviously, what the market's interested in, I guess, the three scenarios you outlined—let's just focus on number one for a second, with the assets, the current assets you have under control, I think was how you framed it. So, that's predominantly Washington, Massachusetts and Illinois, correct, and then you have some assets in, I think, the two smaller states that you have, but predominantly that's Massachusetts, Illinois and Washington; is that correct?

Josh Rosen:

It definitely does include Maryland and Pennsylvania. We have four retail locations in Maryland, three of them licensed, and then we have the dispensary license in Pennsylvania that allows for three locations. So, it clearly has some contributions from those, but disproportionately impacted by Massachusetts and Illinois, as you allude, and I think one of the other things I should hit, and I think will probably be relevant for how you're thinking about this, the only place that we assume enhanced regulatory is in Illinois. We have a high degree of confidence that adult use is coming in Illinois. While we quantify those opportunities looking out, in terms of what I tend to internally refer to it as what are we playing for, we look at that through that lens. So, in Maryland and Pennsylvania, we're not assuming, when we think about maturity, that we've got recreational. We're treating those as commercially viable medical markets.

Doug Cooper:

Right, okay, and that's—I know you didn't put a timeframe on it, but is that a sort of 2020 kind of thing or exit 2020, or how long would it take to fully maximize the value of those assets you currently have or are under assumption?

Josh Rosen:

I've been looking forward for years to being on the other side of these conference calls and having questions like that asked. The 2019, 2020, 2021, frankly, the specific timing attached to this is really, really challenging. That's one of the reasons that we hesitate to go out and put out the 2020 EBITDA number, per se. From our vantage point, we much prefer to frame the opportunity. We will work with folks on helping define how we expect the timeline to work, but I'm going to hesitate to commit to that looking like a 2020 EBITDA number.

Doug Cooper:

Yes. So, maybe I can put it another way. That's the earnings power of those assets that you have in those states?

Josh Rosen:

That is a great way to put it.

Doug Cooper:

Okay, and to maximize the earnings power to get to that, what we just talked about, what kind of capital would need to be outlaid?

Josh Rosen:

I think there are two pieces to this. The first is the existing balance sheet, that upon combination we have, which we think is about US$40 million in liquidity, that covers a disproportionate amount of the ground relative to—if you think about—again, within the confines of those existing assets, the largest capital expenditures we have in front of us really relate to optimizing the Massachusetts assets and optimizing the Illinois assets, as I articulated in the immediate benefits, which we think is a $25 million to $30 million type proposition, in round numbers, and so we think we're well capitalized to capture almost all of that opportunity.

Doug Cooper:

Okay. So, just my quick math would be, based on that earnings power, the stock's trading at about—well, around 5 to 5.5 times EBITDA, give or take. So, based on that—and obviously the market cap today of the Company on a pro forma basis is around US$350 million. The rest of the MSOs are obviously multiples higher than that. In your view, what is the major difference then between what you have on a five-state basis versus some of the MSOs out there?

Anthony Dutton:

Let me jump in first and then maybe you can follow in. So, really, it's just a matter of scale. We think that in terms of the operational integrity and the balance sheet and the skills and the relationships, we've got everything and more that some of these guys already have, save not having as many states, and as you've already heard from both me and Josh this morning, with five states kind of under our belt already and a pipeline in multiple other states, I don't think it's going to take us that long to get there, but I think, really, as I said at the beginning of this call, what's going to separate the men from the boys going forward, and 2019 is going to be a big year for that, is what is your operational skill set, can you operate at scale, and we've looked at a lot of deals—I know Josh has, and we've looked at deals at Cannex—where you see lots of guys who have great projections, they've got sort of an existing foundation of operations, but it's not scaled up.

Doug, you know from having visited a lot of facilities that there's a big difference between having 5,000 square feet and 100,000 square feet of operations. It's not just a linear extrapolation of your skill sets. I am slightly biased, of course, because I'm the CEO of Cannex, but I've been to a lot of facilities over the last 24 months and I can't think of one that holds a candle to what Leo and his team have built in Washington, and I think what really excited us is taking that skill set that we've developed and plugging it into some of these assets currently under control of 4Front, and also some of the other assets that they have a line of sight to.

We're constantly learning, we're always getting better. We don't sort of rest on our laurels thinking that we're the king of the castle, but we are very, very good at what we do, and we're constantly looking for ways to improve. I think what we've presented here today is kind of a base case, if you will, in many ways, and we see so much optionality in the platform with what Josh and his team bring to the table, some of these assets that are really going to benefit from what we bring, some of the retail expertise that they're going to bring to the whole combined platform.

So, to answer your question regarding how we're different from some of the other companies that you might already cover, I don't think we're that different, to be quite honest.

Doug Cooper:

Right, and listen, I think, in my view, I was going to say all states aren't created equal, and Massachusetts and Illinois, clearly, are two of the best ones, in my view. What would be the other states you're not in? You mentioned a few of them. What should we expect to be the next states you're going into and how would you rank them? Michigan seems pretty high on the list, I would think. California, Nevada also pretty high, Arizona. Can you just sort of walk through what you think are the best states to go in and what your priorities are?

Josh Rosen:

Yes, I think you were doing a pretty good job. We definitely place a high priority on Michigan, and that's a natural one, with recreational having just been passed with the voter initiative, implementation on the come still, but we both have acquisition and organic opportunities in Michigan. Behind that, you heard us reference Arizona and Nevada as markets where we think Leo and team's skill set is particularly applicable. Those are states that have ecosystems that look and resemble—about to resemble, at least, what you have in the Northwest and California, where you have ample production, ample feedstock. Taking such a talented processor at scale into those markets just makes a lot of sense, because that feedstock is coming online, and so that's, again, kind of an enhanced lens relative to how we look at the world. For us, Nevada retail is still quite interesting, and we're spending a decent amount of time there.

Then, I referenced we will continue to look at opportunities to expand now on the vertical integration side in the Pennsylvanias and Marylands of the world, and then be opportunistic as other opportunities arise. I think, going back to your last question, we're not a group that prioritizes filling a map for filling a map's sake. We will really focus where we think we can bring that operational integrity and execute, and I think if there's something that differentiates us, it actually is that. Perhaps to a fault sometimes, we're going to stay disciplined about where we think we can execute and what those return profiles look like. So, maybe we don't look exactly like everyone else.

Doug Cooper:

Great. Congratulations. That's it for me, thanks.

Operator:

Our next question is from Alan Brochstein with New Cannabis Ventures. Please proceed with your question.

Alan Brochstein:

Yes, thanks for taking the call, and congratulations on this pending acquisition. My first question is just about—I've heard this crazy talk. You guys talk about positive net income. There's a couple of other multi-state operators, I know you don't like that term, Josh, necessarily, but talking about things like EBITDA and free cash flow. I'm just wondering, as you think ahead and given that you don't want to necessarily play Monopoly, should investors expect that you'll be focused on that metric or do you subscribe to the Canadian style that's been adopted by some of your competitors to just build it any cost, right? I just want to hear how that's going to play out from your perspective.

Josh Rosen:

Well, yes, I mean, I think you—I think I referenced the game of Risk rather than the game of Monopoly, where geography is still important, and understanding the market opportunities as they present themselves is still really important, and we definitely take what I would call a longer term, intermediate, longer term lens on the industry in terms of how it will develop and where we can play and add value. So, what I would say is I think we'll be a hybrid. I think we will be—using Washington as an example, we're not going to put a lot of incremental resources into a market like Washington, for fairly obviously reasons, but where we see an opportunity to drive strong returns over an intermediate time period, we will continue to invest heavily, and so I don't think you're going to see us with excruciating focus on driving positive net income and positive EBITDA as a whole organization at the expense of future growth, I think you're going to see us be a hybrid between the two, and then hopefully be able to articulate as we go into those markets where we do have that operational integrity showing through and not as much of an opportunity set to continue to invest, that we are generating profits, and we are both highly efficient from an operational standpoint, as well as driving brands and what I would refer to as more of a durable, sustainable profit stream.

Alan Brochstein:

Few have their finger on the pulse of the industry as you do, but do you feel as though some of your competitors are overspending on acquisitions and not treating capital properly?

Josh Rosen:

Rather than comment specifically on the competitors, what I'll say is our lens—our lens is one that—the measure of a company over time is how you deploy capital, not how you raise capital. So, while we're really keyed in on whether and how folks generate their cost of capital, and that cost of capital advantage that exists in the industry, we're just as keyed in on making sure that we're smart with how we deploy capital and use shareholders' money. I think this industry requires—well, it doesn't require it right now, but I think it will require a balanced approach to that, which is what we're trying to take. Some of our competitors, have they attained a cost of capital advantage and built balance sheets? I think that's accurate, and I applaud them for it, they've played this very well, to get to that point. How they utilize it and how they execute against it, I think the jury's still out.

Alan Brochstein:

Okay, and then one last question. I don't know if you can speak about the Jetty Extracts, the reasons that that didn't work out. If you can, great. If not, it's not a big deal. I am curious, going forward, if part of your strategy would be to pursue brands like that, or is it really going to be focused more just on the retail and cultivation side?

Anthony Dutton:

I'll take that question. With specific regards to the Jetty Extracts transaction, you know, great guys and a fantastic Company. I think what we realized over the last—this is "we" being Cannex—over the last six months, just as we kind of really refined our strategy, as I articulated in the first three points of my intro to Josh, we just felt, I think, internally that the strategic direction in which we were going was going to be better served by following an option, as we are now following with 4Front. I think that's ultimately going to be where we want to go, and I think it was the right decision for our Company.

Josh Rosen:

The second layer of that, Alan…

Anthony Dutton:

Sorry, Josh.

Josh Rosen:

Yes, no, I was just going to hit the second layer of your question, because I think Jetty ties in. I think, if you look at 4Front's philosophy going back, one of the reasons that this acquisition—or this combination and then talking about the Jetty acquisition, one of the reasons this topic is so interesting to us is we for long have said it's interesting that, by and large, the large multi-state operators have been east of the Mississippi, well capitalized, but not coming from the mature operational heritage of what you have west, nor—they're developing brands.

We're developing brands on our own organically, as well, but what I would say is we can spend a decent amount of money on Madison Avenue, but there's still not a lot of history, necessarily, authenticity to all that branding work that's being done, whereas the stuff coming out of California, Jetty being a good example, has a little bit more of that authenticity rigor behind it and just the legacy. I'm actually pretty close with Ron, who runs Jetty, and you can be rest assured I had a conversation with him about this as we looked at what we were trying to accomplish, and I think, by and large, we do see opportunities to bring western brands east. All of that said, the capability set is what we're most about. We think bringing the operational integrity, driving those operations, will afford a lot of branding opportunities going forward.

Anthony Dutton:

I just want to echo one of Josh's last points about capital because we think about this internally at Cannex constantly, it's the access to capital, the cost of capital and the allocation of capital. Typically, when we say those things, people are always thinking about money, but there's a huge human capital component to this industry, and given that it's a new industry, skill sets, management skills, operational skills are harder to come by than you would actually expect.

So, when you've got a phenomenal team, like what we've built and what Leo has built in Washington with his original NWCS partners, and when you've got the team that Josh has built around 4Front and multiple silos around licensing and retail and business development, that is just as valuable, if not more valuable, than the actual cash on your balance sheet because, ultimately, your company is going to be driven by the ability of your management and your human capital to make smart decisions about how you deploy the actual cash capital. It's something that we're very, very pleased with in regards to our relationship now with 4Front, because we do have very complementary matching skill sets, and that's going to be, I think, very well served in creating long-term shareholder value, sustainable long-term shareholder value built on a very strong foundation of operation.

Alan Brochstein:

Sounds great. Thanks again for taking my questions and congratulations.

Anthony Dutton:

Thank you.

Josh Rosen:

Yes, thanks, Alan.

Operator:

Our next question is from Matthew Wosk with Proficio Capital Partners. Please proceed with your question.

Matthew Wosk:

Anthony and Josh, congratulations on a truly transformative deal. My question was answered earlier, so you can just move on to the next question, but congratulations, guys, once again.

Josh Rosen:

Thanks, Matthew.

Anthony Dutton:

Yes, thank you.

Operator:

Our next question is from Eric Zachs with Bantry Bay Ventures. Please proceed with your question.

Eric Zachs:

Hi, guys. Congratulations. Echoing Matthew and everyone else. I think, strategically, you're doing absolutely the right thing. I'm just curious—because, obviously, Washington State prices have come down tremendously—what is your average cost for growing, and do you have a target of what you're shooting for, so that you remain competitive in what will be a business that, as you say, operational excellence is going to really matter?

Anthony Dutton:

The question is what's our cost on the cultivation side?

Eric Zachs:

Right, per gram.

Anthony Dutton:

On the cultivation side, it's in the sort of $0.65 to $0.75 per gram range. On the wholesale pricing side, it's anywhere from $1.80 to $2.50. It's come off from highs of $3.50 to $4 a gram at wholesale. Then, the other big component of our business in Washington is obviously our derivatives business, and we're using our own trim and sometimes full flower to process for the extraction to manufacture the (inaudible) for the edibles, and we are more often processing our own material—we process our own trim, obviously, but we're buying that on the open market from outdoor grows, greenhouse grows, anybody that we can get it from, and we're paying often prices which are lower than we could grow it for.

We think about our business as having, obviously, the flower side, but more and more so on the derivatives side, the market is trending not only in Washington, but right across the consumer base, from less derivatives to more derivatives. I think in Washington, it's about 70% flower, 30% derivatives. We're skewed more heavily towards derivatives, about 45%. We like that because the costs of input are lower. We like that because the margins are higher. We like that because it's easier to build a brand around what we call a value-add manufactured product. So, for sure, the prices have come off. Though, on the one hand, it's kind of hurting us a little bit on the flower side, but we make that up on the cost of input materials on our derivatives side.

Does that answer your question?

Eric Zachs:

Yes, no, that's perfect, and just looking out a couple of years—because, obviously, things have changed so much in these last few years in the pricing—do you have a target of what you'd like to be shooting for, you know, 2020-ish?

Anthony Dutton:

In terms of pricing, you mean?

Eric Zachs:

Well, in terms of your price, continuing to drive costs and efficiencies down.

Anthony Dutton:

That's really more of a Leo question, but I know Leo pretty well, obviously, and he's obsessed with operations and always improving, so we like to think of ourselves as being the lowest cost operator we can be, given the information that we have, but he and his team are literally digesting information on a daily/weekly basis and looking at ways to improve margins, lower costs. One of the things that we see with having a multi-state platform now with a company like 4Front is that we're going to have the benefits of scale, so things like centralized purchasing, allocation of capital across multiple operations, centralized equipment purchasing, leasebacks, master service agreements, all those sorts of things, which are ultimately going to be good for not only our Washington-based operations, from a cost structure, but right across the whole Company.

Again, as I said at the very beginning, I think in two or three years, when people have kind of gotten over the fact that it's a cannabis company, they're going to be looking at you for your operational excellence, and they're going to be looking at these types of things, so we're very, very focused on that, and I know Josh is, as well.

Josh Rosen:

Yes, Eric, just to give a little color relative to our lens on this. Particularly the second facility, the newest cultivation, indoor cultivation facility that Leo developed, if they can make greater—if they can add yield and pick up cost efficiencies over time, happy day. What I will tell you is we've not seen facilities that are that productive, that can still generate what I'd call meaningful EBITDA margins, if you normalize numbers, at a price point—call it $600, $800, $700, $900 a pound, in terms of sales price. If we can just replicate that—and I think replicate that is probably—it won't be where our assumptions start, we think it's going to take some time, but picking up more efficiencies in Washington is going to be much less important than getting close to those efficiencies elsewhere, where we think we will be a clear market leader as we drive that operational integrity.

Eric Zachs:

No, I agree with you 100%. Over time, probably, that Washington experience, you'll be taking that elsewhere and continuing to refine the efficiencies.

Josh Rosen:

We're also seeing—it's an interesting anecdote relative to how people think about this market pricing environment in different states over time. It feels like Washington, and Oregon to a degree—I have less insight into Oregon, we spent much less time there—is stabilizing to a degree on the pricing side. Obviously, there's seasonality in these markets that have a lot of outdoor crop. But, frankly, the price point now is at a spot that, unless you're hyper-efficient, it's really hard to make money.

Eric Zachs:

(Inaudible)

Josh Rosen:

(Inaudible) quite a bit more stability, exactly. So, we're seeing some folks fall out. It should help that supply/demand imbalance over time.

Eric Zachs:

Okay, thanks, and congratulations. I think, strategically, it absolutely makes a ton of sense what you're doing.

Operator:

Our next question is from Charles White, Private Investor. Please proceed with your question.

Charles White:

Hi, yes. So, I had a question on the 4Front side of things. With the recent raise you guys had and just on doing some paper math from the numbers we've been given, is there going to be any dilution to current shareholders for this transaction, or is the share count for 4Front going to remain around where it is right now?

Josh Rosen:

It's a touch complicated. To answer the question directly. We viewed this from a lens, from a capital markets lens, at least, not terribly dissimilarly than what an RTO transaction would have led to. Obviously, the strategic benefits and the numbers are quite a bit different, but, frankly, the outcome to our 4Front stakeholders, we expect, will be quite similar. Effectively, the 4Front stakeholders and the 4Front shareholders in this, investors, will be receiving a form of Cannex, and it should not be dilutive in the standard sense, in the sense of, yes, it should be quite a bit higher, hopefully, than where it was during the last round of capital that we raised. Where it is dilutive, relative to what a shareholder owns in terms of the percentage of the Company, if you just use the simple math of that ratio, obviously, we're adding a partner that's greater than a third of ownership in the combined entity, so it definitely has that characteristic attached.

Charles White:

All right, and also for the 4Front shareholders, how is the interest on that accruing? Is that going to be accruing in share count, or how is that going to happen between now and the proposed merger date?

Josh Rosen:

Great question, that I've not, frankly, spent time thinking about yet. That specific mechanic, we're working through the mechanics of that right now, in terms of taking our LLC structure through those mechanics. I believe, if I recall correctly, and I'll have to go back and refer to the docs on our side, (inaudible) public stuff, but I believe that we have the option either to pay that interest out, or it'll just convert into those incremental shares of Cannex, as described in this case, but I'm not 100% certain of that answer.

Charles White:

All right, thank you very much. Great deal, happy to hear about it.

Josh Rosen:

Thank you.

Operator:

We have reached the end of our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

Anthony Dutton:

Josh, do you want to close up?

Josh Rosen:

I am happy to. I think, broadly speaking, much like I stated at the outset, we've got a really unique opportunity here in terms of the platform, with the differentiation being less about being an MSO, although we are that, and more about really applying best-in-class operating capabilities across a number of opportunities, and so from our vantage point, we couldn't be more excited about what we're putting together here and really having that capability set across the value chain. I anticipate, based upon what we're seeing on this conference call, a lot of good questions to come, and between myself and Anthony and Andrew on our team, I anticipate we'll probably be running into a large number of you over the coming weeks and months.

Anthony, if you have anything else to say, please feel free, but I really appreciate everyone joining us today.

Anthony Dutton:

I just wanted to say that, as people know from having read the news release, that upon closing, I'll be moving over to a capital markets and business development role, Josh will be taking over as CEO. I could not be more pleased about that. I know this is the first time for many of you to have spoken to him, but he's a phenomenal operator, excellent CEO, and I think that he's going to do a great, great job. It's going to be a lot of fun to work with his team and the expansion of our team all coming together under the same roof. We could not be more excited, and, again, thank you very much, everybody, for your participation today.

Operator:

Thank you. This concludes today's conference. You may disconnect your lines at this time and thank you for your participation.