

6 May 2020

### Healthcare

52-WEEK HIGH	C\$0.79
52-WEEK LOW	C\$0.30
PRICE	C\$0.79
MARKET CAP MLN	C\$152.50

### Share Price



### Major Shareholders

No holders above 10%	
Primary Index	CSE
Next Key Announcement	June 2020

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## CanaFarma Hemp Products Corp - Initiation

### The CanaFarma business model

CanaFarma Hemp Products Corp. (CSE:CNFA, FRA:4K9) produces a range of hemp-derived products for the consumer wellness market. The company has a vertically integrated 'farm-to-table' strategy encompassing cultivation, extraction/process, manufacture of branded consumer products, and sales & marketing.

Within the fast-growing market for hemp-based products (28% annual growth trend, see p4-5), CanaFarma is differentiated by a powerful and tested direct-to-consumer (DTC) marketing engine, and a product range that is scientifically validated and consistent quality.

### Milestones delivered to date

In 2019 CanaFarma cultivated a 55 acre licensed hemp growing site in New York state, producing 128k pounds (lbs) of hemp, and exceeding industry productivity benchmarks. The company is now seeking suitable sites for cultivation on the required scale to support its future operations.

Also during 2019, the company achieved US\$2.8mln of sales of consumer-branded products, at a peak run-rate of more than US\$600k per month via its DTC marketing channels, using products manufactured for CanaFarma by a third party. The DTC marketing strategy is an important driver for the company, and the results achieved in 2019 give an indication of the potential revenue ramp-up going forward.

### The next steps, and financial outlook

CanaFarma is in the process of acquiring a manufacturing facility to produce its branded products, and we believe that this could be operational by the third quarter (Q3) of 2020. Hemp oil extraction will be undertaken via third party facilities until the company has established and licensed its own extraction and processing facilities. Negotiations are ongoing, and we believe that a processing site could be acquired by the end of 2020.

### Financial outlook

In this report, we present an overview of the operating outlook and financial trajectory of CanaFarma. The company has an aggressive expansion strategy, and we believe that there is a clear pathway to strong revenue growth. This is underpinned by the results already achieved by the DTC marketing engine, and by the strong underlying growth in the market.

Furthermore, in this report, we examine the profitability dynamics of the different operations within CanaFarma. We conclude that revenue growth can be converted into profitability on a rapid timeframe. Finally, we examine the capital commitment that is required to deliver on these growth plans. We conclude that CanaFarma has sufficient cash resources to execute the next phases of its business plan without being obliged to seek any fresh capital.

Based on our financial forecasts for the company, we argue that the current valuation (market capitalisation of C\$152mln) represents an interesting entry point for investors.

Year end Dec 31	Current	2021	2022	2023
Revenue (US\$M)	6.00	39.00	99.00	160.00
EBITDA (US\$M)	(2.85)	3.40	22.40	48.60

## David Lonsdale, chief executive officer (CEO)

Lonsdale served as president and CEO of the Lonsdale Group, a boutique finance and advisory firm. He also held the role of president at Allegiance Capital Corporation for more than 10 years. He has successfully built and sold three venture-funded information technology companies. He holds an MBA in finance & marketing from Cornell University

## Frank Barone, chief operating officer (COO)

Barone spent 18+ years as co-founder of several companies that specialised in marketing nutritional supplements and cosmetics, and was previously COO of a holding company for two SEC-registered broker-dealers.

## Four components of the CanaFarma business model

### Investment summary

CanaFarma is a company providing innovative cannabinoid-formulated products for consumer wellness. The company has adopted a vertically integrated business model, encompassing four key components:

- **Growing high-quality hemp:** CanaFarma (via its subsidiary, Simple Solutions) was one of the first entities to be granted a hemp cultivation licence by the State of New York. In 2019, the company produced about 128,000 pounds of hemp from its acreage. Additional facilities under negotiation will allow CanaFarma to fully cultivate/source its own hemp for its branded products, while profitably selling the remainder of its crop as commodity biomass to supplement cash flow.
- **Extraction and processing:** CanaFarma is currently in discussions with two potential extraction and processing facility opportunities in the State of New Jersey. In addition to giving CanaFarma operational flexibility to process hemp for its branded products, CanaFarma expects to process significant amounts of hemp for third parties at comparatively high-profit margins.
- **Manufacturing:** CanaFarma has begun selling its first three products (chewing gum, tincture, and cream) under a private labelling agreement. The company is in the process of acquiring a manufacturing facility in New Jersey, which could be operational in the second half of 2020.
- **Direct-to-consumer (DTC) marketing engine:** CanaFarma has begun to market and sell its first two products through a proprietary network of affiliate-marketing "influencers" who are engaged to drive customers to CanaFarma's presence on the Internet. More details on p6.

The following table summarises the four components.

<b>Cultivation</b>	128,000 lbs of hemp from original 55 acre site. Further capacity planned
<b>Processing</b>	Target to acquire facilities in 2020
<b>Manufacture</b>	In the process of acquiring facility in NJ and FDA approval
<b>Marketing and sales</b>	Proven DTC marketing channel, delivered US\$2.7m revenue in 2019

The company has already been selling a range of products under its proprietary brands YOOFORIC (chewing gums tinctures and creams) and Herbal State of Mind. The revenues from these brands have demonstrated the effectiveness of the DTC marketing engine in acquiring new customers.

The key to retaining these customers is to provide a product with demonstrable superior quality. The market place for hemp-derived products is a new and emerging space, and there are many new products on offer that do not actually contain the cannabinoids that are advertised or do not deliver these in an absorbable form. CanaFarma is applying a scientifically validated approach to develop products that offer high absorption rates and full spectrum phyto-cannabinoid content.

One of the main benefits of the vertically integrated strategy is that CanaFarma can be assured of obtaining the correct quality of raw hemp and hemp oil via its own cultivation and extraction. Additionally, we believe that in 2020 and 2021 the sale of 'surplus' biomass and hemp oil will provide an additional stream of cash flow for the company. In future years we believe there is potential for pricing pressure on these raw commodities, but by this stage, we believe that CanaFarma will have substantially expanded its consumer products revenues.

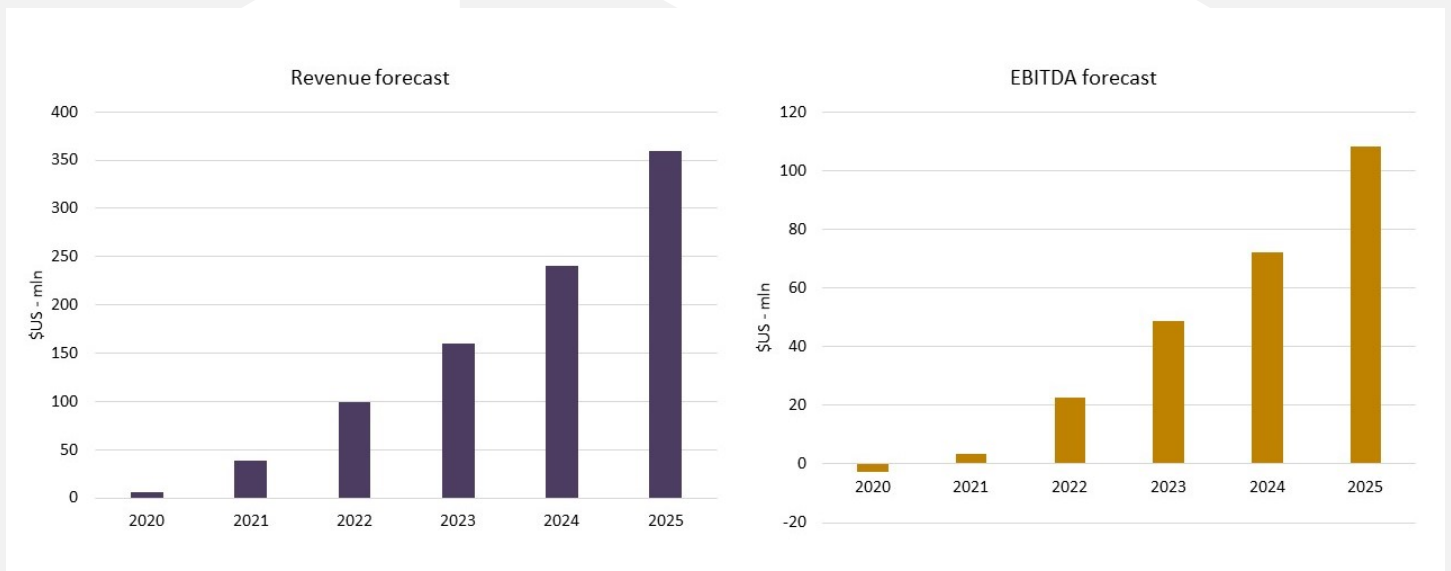
**Differentiators:**

In summary, we believe that CanaFarma benefits from three key differentiators in delivering its strategy:

- A superior range of products offering high absorption rates and full-spectrum hemp oil content.
- A powerful DTC marketing engine that has already delivered tangible results.
- An executive team that brings together expertise in affiliate marketing as well as specifically in consumer wellbeing products.

**Financial potential:**

The results of the early stage DTC marketing efforts in 2019 provide a roadmap for how revenue streams can be ramped up as CanaFarma begins to get its full suite of products and capabilities in place. The following charts show our forecasts for revenue and underlying earnings (EBITDA) out to 2025.



Source: Proactive Research

**The CBD market**

Hemp oil is being increasingly used as a consumer wellbeing product as individuals become more aware of the beneficial effects of cannabidiol (CBD) and other natural constituents.

The market for hemp-derived products has grown strongly since the US government passed the Farm Bill in December 2018, which legalised the cultivation, processing and sale of hemp. For these purposes, hemp must contain less than 0.3% concentration of tetrahydrocannabinol (THC) which is the psychoactive ingredient in cannabis and which remains illegal in the USA.

Academic studies have shown that CBD offers a range of possible health benefits. The following source materials provide a starting point for further reading:

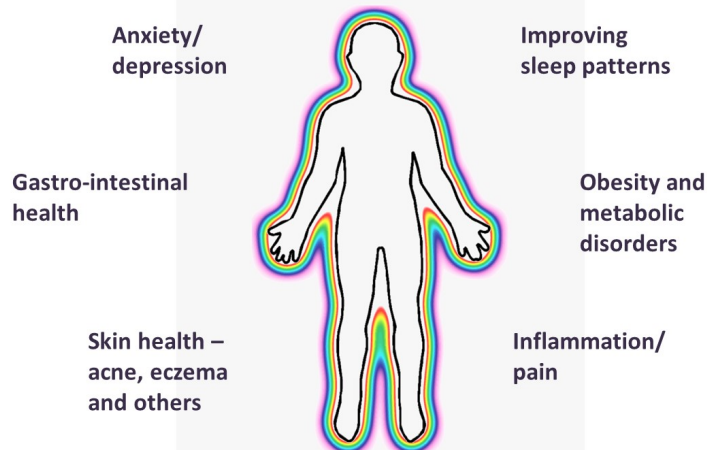
<https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3026637/>

<https://www.health.harvard.edu/blog/cannabidiol-cbd-what-we-know-and-what-we-dont-2018082414476>

The following schematic highlights some of the benefits:

Hemp-derived products offer consumers a wide range of potential health benefits

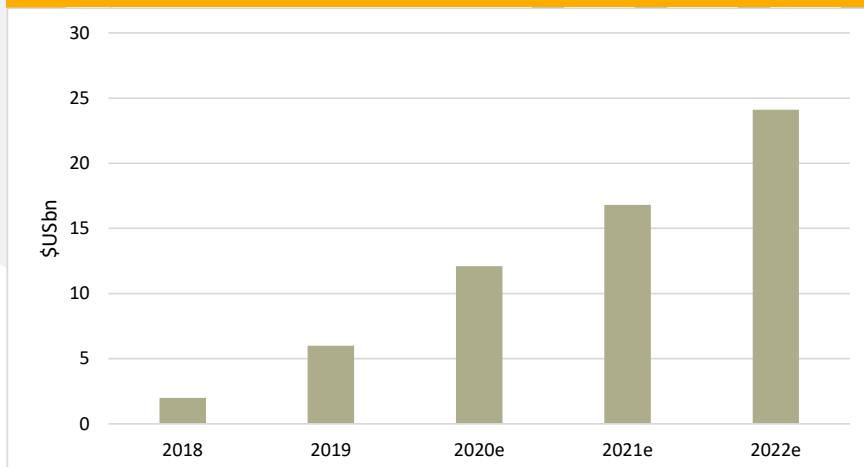
Consumers are using CBD for these conditions (amongst others)



Source: Proactive Research

The market for hemp-derived products continues to grow as more consumers learn about the potential benefits and a wider range of products become available. The following chart shows the market for hemp-derived CBD products.

Hemp-derived CBD products market



Source: Brightfield Group, Yahoo Finance

This remains an immature market, and low-quality products remain prevalent – products that do not offer the full spectrum of hemp-oil constituents or that offer low absorption rates. The mission of CanaFarma is to provide high-quality hemp-oil products and to build brands that are trusted by consumers.

**The CanaFarma business plan**

During 2020 CanaFarma expects to establish operational capability in each of its four business activities – cultivation, extraction, manufacture and sales. Of particular importance is the DTC marketing model, which has already delivered US\$2.7mln under the initial private-label products marketing exercise in 2019.

**The marketing model**

The company targets online sales using an affiliate marketing strategy – paying “influencers” to generate traffic to the CanaFarma selling portals and also to

The affiliate marketing platform is a key element of CanaFarma's business strategy

generate completed paid sales of products. There are two related models in operation:

Cost-Per-Sale (CPS) is a low risk, high profit, revenue-sharing model used to attract new customers. Cost-Per-Sale pays a set commission to the affiliate marketer who refers a lead that results in an actual purchase. This is a risk-free approach from CanaFarma's point of view because the company will only pay a commission when an actual sale is delivered. The commission payable is usually somewhat higher than under the alternative 'CPA' model.

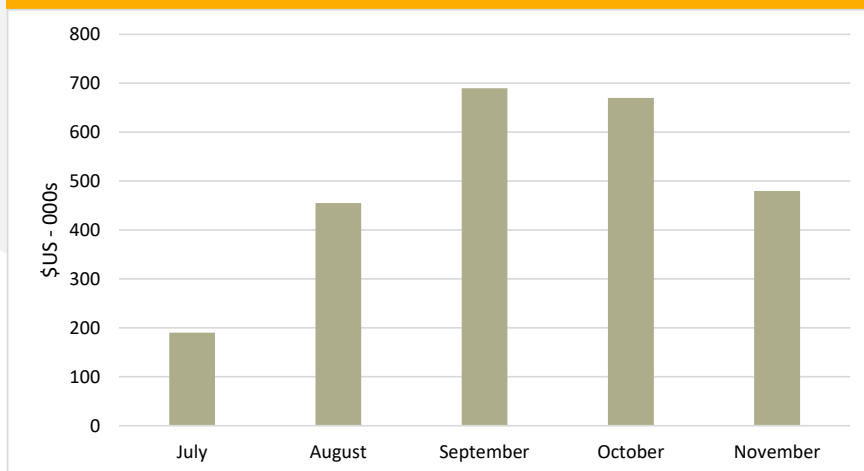
Cost-Per-Action (CPA) marketing programmes pay affiliates when a specific action is taken by the referral or lead, such as a visit to one of the CanaFarma sales websites. This means CanaFarma will sometimes be paying out for referrals that don't lead to a sale. The payout percentages are far less than they are in Cost-Per-Sale.

The company uses both marketing models, with a lower rate of commission for CPA than for CPS. The company applies proprietary data analytics to identify where web traffic referrals are converting efficiently into sales so that the CPA approach can be used in a targeted fashion.

CanaFarma applied its affiliate marketing strategy in 2019 to sell some private label (3<sup>rd</sup> party manufactured) products produced under its YOOFORIC brand. This generated rapid growth in revenue, and generated market data that will be used when the company's full range of in-house produced items enters the market. The following chart shows the sales generated in 2019:

Revenue run-rate of over US\$600k per month was achieved in the initial affiliate sales push

Revenues from affiliate sales 2019



Source: CanaFarma data and Proactive Research estimates

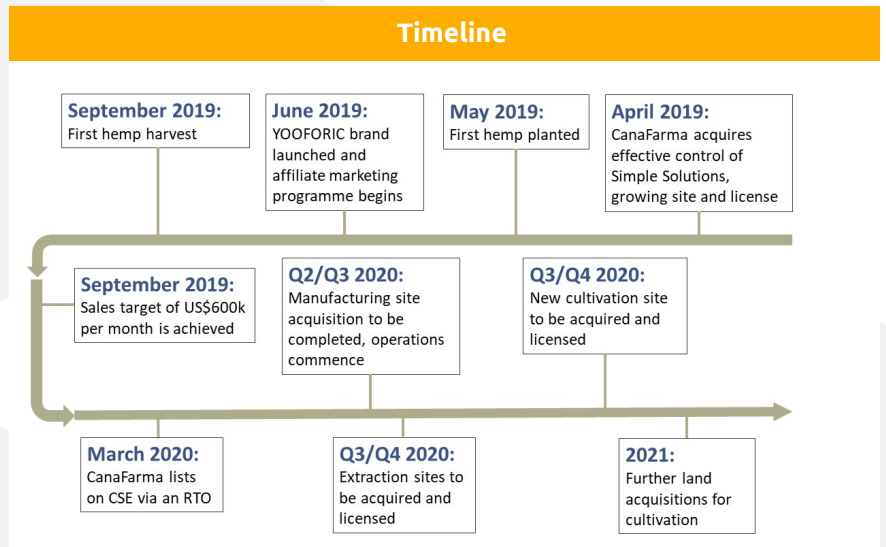
The results of this marketing programme included:

- A realised revenue run-rate of over US\$600k per month.
- A strong conversion rate of referrals to sales.
- Ability to sign customers under a monthly subscription model.

#### Key milestones

CanaFarma has an ambitious rollout plan for its full suite of capabilities. The following timeline shows the key milestones in terms of objectives achieved and additional targets for 2020 and 2021.

Major commercial milestones already delivered, aggressive strategy to complete the suite of capabilities



Source: Proactive Research

Note that the listing of CanaFarma on the Canadian Securities Exchange was achieved via a reverse takeover with a company called KYC Technologies in March 2020. Regulatory filings on the SEDAR system before March 2020 relate to KYC, which is a business unrelated to CanaFarma.

The timeline of major operational events is as follows:

**Cultivation:**

CanaFarma cultivated a 55 acre site in Dutchess County New York in 2019, producing 128,000 lbs of hemp.

The company is now looking at new sites that can be used to produce hemp on a sufficient scale for future operations. A site in New Jersey is being considered that would include 75-100 acres for growing, with an onsite extraction facility. Further acreage is being examined in the state of New York.

**Extraction/processing:**

CanaFarma will begin hemp oil extraction operations this year, from a third-party-owned facility. The company is examining acquisitions of extraction and processing facilities in New York or New Jersey, which could be completed later this year.

**Manufacturing:**

CanaFarma is discussing the acquisition of a manufacturing facility in New Jersey which could be completed in the second quarter (Q2) or Q3 of 2020, with manufacturing to start up soon thereafter. The company signed a letter of intent on a manufacturing facility in April 2020.

**Marketing:**

The DTC marketing engine has already been fully operational in 2019 and will be re-activated when the company begins to market its re-packaged product line in Q2 2020.

**The team**

To deliver on its aggressive growth strategy, CanaFarma has assembled an executive team that brings together expertise in marketing, consumer wellbeing products, and cultivation.

**David Lonsdale, chief executive officer (CEO)**

- President and CEO of the Lonsdale Group, a boutique finance and advisory firm. For more than 10 years he was president of Allegiance Capital Corporation, a private investment bank
- Successfully built and sold three venture-funded information technology companies, including selling one of them to Microsoft
- MBA in finance & marketing from Cornell University

**Frank Barone, chief operating officer (COO)**

- 18+ years co-founding several companies that specialised in marketing nutritional supplements and cosmetics. Extensive experience in off-line and on-line (e.g., affiliate marketing, search engine optimisation, social media) marketing
- Before 2002 he was the COO of a holding company for two SEC-registered broker-dealers

**Kiril Chumenko, senior vice-president**

- The co-founder of several companies that specialised in marketing nutritional supplements and cosmetics, he was responsible for on-line affiliate network relations
- Senior international financial analyst within the emerging markets division at JP Morgan Chase

**Carl Germano, Vice President, Verdant Oasis (Strategic Partner to CanaFarma), NY Board Certified Clinical Nutritionist**

- Verdant Oasis is a major cultivator and grower of full spectrum phytocannabinoid rich hemp oils

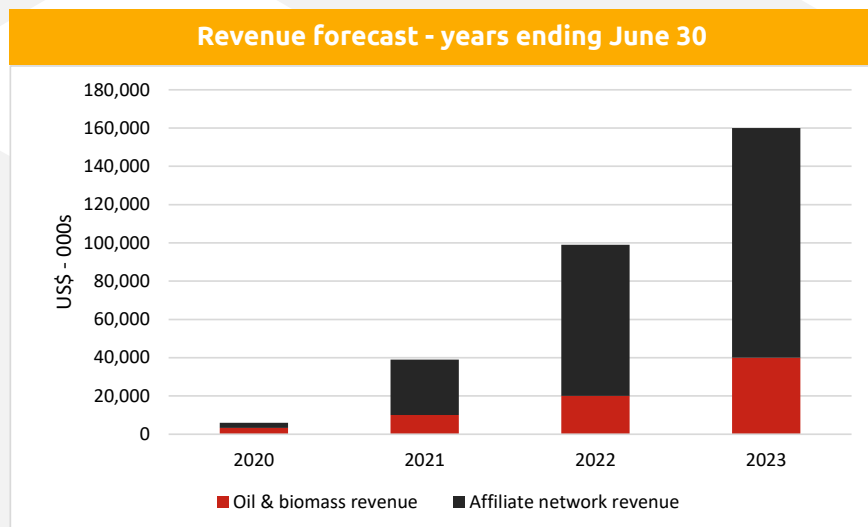
- Carl Germano has 40+ years of product development experience in the dietary supplement and cannabinoid industries

### Financials

CanaFarma benefits from compelling growth drivers, both in terms of the growing end market, and the company's differentiated product range and proven marketing strategy.

The following chart shows our revenue forecast for FY June 2020 – 2022 broken down into two revenue segments.

**Affiliate network revenue (consumer products) will be the primary revenue growth driver**



Source: Proactive Research

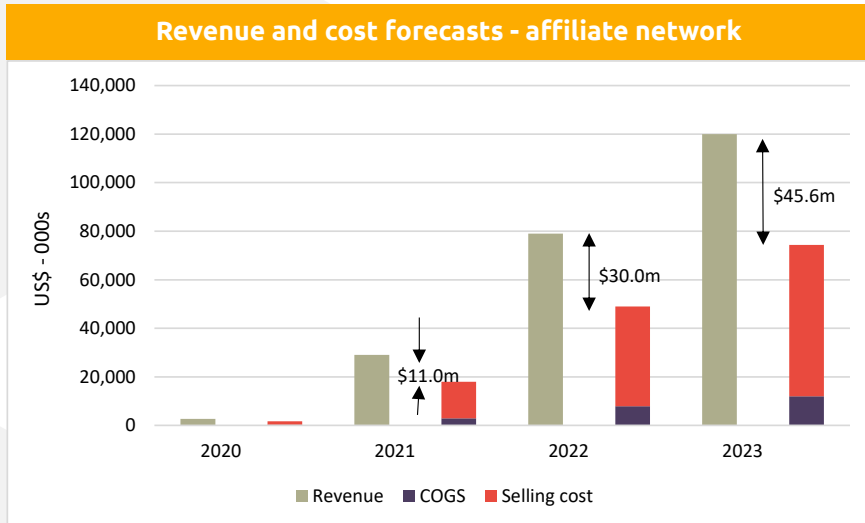
In 2020 and 2021 we believe that the revenues from wholesale biomass and oil will make a significant contribution to the company's earnings. Going further forward, we expect that most of the biomass and oil produced will be used in-house, and the earnings stream becomes increasingly driven by the revenue from branded consumer products sold through the affiliate marketing engine.

The consumer products revenue stream has a different profitability profile than biomass or oil sales. We believe that consumer products can generate a very high gross profit margin. Our modelling assumption for this segments is 90% gross profit. A significant selling cost is incurred under the affiliate marketing model. In our forecasts we assume a selling cost of 52%. This is a variable cost that moves in line with revenue as affiliates are paid in proportion to the sales they generate (or web traffic in the case of CPA agreements).

The following chart shows our forecast for the EBITDA contribution from affiliate sales through to FY June 2023.



A strong 'drop-through' of incremental revenues into profit



Source: Proactive Research

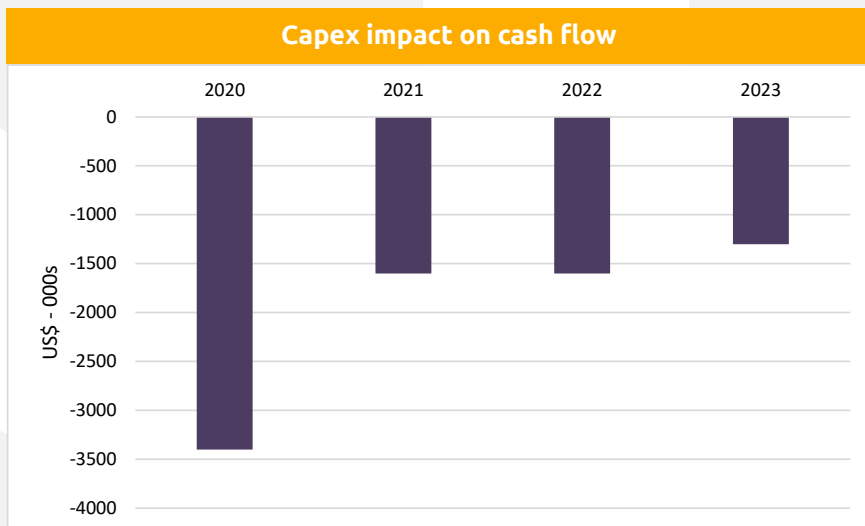
Based on these parameters we believe that CanaFarma will rapidly move into profitability (full-year, or FY, to June 2021) with earnings growing from there. Full details of our model are on p11-12.

#### Capital requirement

CanaFarma reported US\$2.7m of cash on its balance sheet at 31 December 2019, and we believe this is sufficient to fund the current business development pipeline.

The following chart shows the major capital expenditure requirements in the next few years.

Limited requirement for capital investment in the years ahead



Source: Proactive Research

The major items driving this capital expenditure are:

FY 2020: Acquisition of land, extraction/processing facilities, manufacturing facility

FY 2022: Further acquisition of land

We believe that future growing contracts are likely to be on the basis that the contractor provides the equipment, hence additional growing sites will require

less capital expenditure (capex) than was the case for CanaFarma's first year of cultivation.

**Conclusions:**

We argue that CanaFarma has the strategy and the set of capabilities to deliver strong revenue growth. Furthermore, we believe that there is a rapid pathway to profitability. And finally, we believe that these objectives can be achieved without a necessity to attract any additional investment capital.

Based on our forecasts we argue that the current market cap of C\$152mln represents an undemanding valuation on the shares.

### Financial models

The following tables summarise our financial forecasts for CanaFarma Hemp Products Corp and its subsidiary (CanaFarma).

<b>Income Statement</b>				
<b>Year end June, \$m</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
<b>Revenue</b>	<b>6.0</b>	<b>39.0</b>	<b>99.0</b>	<b>160</b>
Cost of sales	(2)	(18)	(49)	(76)
Gross profit	4	21	50	84
Operating expense	(7)	(17)	(27.4)	(35)
<b>Adj. EBITDA</b>	<b>(2.9)</b>	<b>3.6</b>	<b>22.6</b>	<b>48.6</b>
Non-cash remuneration	-	(0.2)	(0.2)	(0.2)
<b>EBITDA</b>	<b>(2.85)</b>	<b>3.4</b>	<b>22.4</b>	<b>48.4</b>
Amortisation	(0.1)	(0.2)	(0.2)	(0.2)
Depreciation	(0.1)	(0.2)	(0.2)	(0.2)
<b>EBIT</b>	<b>(3.0)</b>	<b>3.0</b>	<b>22.0</b>	<b>48.0</b>
<b>Earnings before Tax</b>	<b>(3.0)</b>	<b>3.0</b>	<b>22.0</b>	<b>48.0</b>
Income tax expense	-	(0.9)	(5.9)	(13.0)
<b>Net income</b>	<b>(3.0)</b>	<b>2.2</b>	<b>16.1</b>	<b>35.0</b>
Non-controlling	1.3			
<b>Attributable earnings</b>	<b>(4.3)</b>	<b>2.2</b>	<b>16.1</b>	<b>35.0</b>
<b>EPS (dil., continuing op.s) - US\$</b>	<b>(0.02)</b>	<b>0.01</b>	<b>0.08</b>	<b>0.18</b>

<b>Balance Sheet</b>					
<b>Year end June, \$m</b>	<b>2019</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Cash and equivalents	1.3	1.1	0.7	8.9	43.6
Accounts Receivable	0.1	1.2	3.9	6.9	11.2
Biological assets	0.5	1.0	3	5	7
Inventories	0.0	0.4	2.7	6.9	11.2
Prepayment & others	2.1	3.3	5.9	14.9	24.0
Property, Plant and Equipment	0.1	3.5	4.8	6.2	7.3
Intangibles & goodwill	0.9	0.8	0.7	0.5	0.4
<b>Total Assets</b>	<b>5.0</b>	<b>11.3</b>	<b>21.7</b>	<b>49.3</b>	<b>104.6</b>
Deferred tax	-	-	0.9	6.8	19.8
Accounts payable	0.0	1.1	2.9	3.5	4.8
Accrued expenses	0.5	1.4	5.0	7.0	9.0
<b>Total Liabilities</b>	<b>0.5</b>	<b>2.5</b>	<b>8.8</b>	<b>17.3</b>	<b>33.6</b>
Share capital	0.1	6.1	8.1	11.1	15.1
Premium	5.6	5.6	5.6	5.6	5.6
Retained earnings	(1.2)	(4.2)	(0.8)	15.3	50.3
Reserves	-	0.0	0.0	0.0	0.0
Non controlling interest	(0.1)	1.16	(0.0)	(0.0)	(0.0)
<b>Shareholders' equity</b>	<b>4.5</b>	<b>8.8</b>	<b>12.9</b>	<b>32.0</b>	<b>71.0</b>
<b>Liabilities and shareholders' equity</b>	<b>5.0</b>	<b>11.3</b>	<b>21.7</b>	<b>49.3</b>	<b>104.6</b>

<b>Cash Flow</b>				
<b>Year end June, \$m</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
PBT	(3.0)	3	22	48
Depreciation/amort	0.2	0.4	0.4	0.4
Inventories/Bio assets	(0.9)	(4.3)	(6.2)	(6.3)
Receivables/prepayments	(2.3)	(5.3)	(12.0)	(13.4)
Payables	2.0	5.4	2.6	3.3
Total WC	(1)	(4)	(16)	(16)
Share-based payments	0.9	2.0	3.0	4.0
<b>Operating cash flow</b>	<b>(3.2)</b>	<b>1.2</b>	<b>9.8</b>	<b>36.0</b>
Capital expenditure	(3.4)	(1.6)	(1.6)	(1.3)
Additions to intangibles	-	-	-	-
<b>Cash flow from investing</b>	<b>(3.4)</b>	<b>(1.6)</b>	<b>(1.6)</b>	<b>(1.3)</b>
Share issue	6.4	-	-	-
<b>Cash flow from financing</b>	<b>6.4</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Increase (decrease) in cash</b>	<b>(0.2)</b>	<b>(0.4)</b>	<b>8.2</b>	<b>34.7</b>
Fx	-	-	-	-
<b>Increase (decrease) in cash</b>	<b>(0.2)</b>	<b>(0.4)</b>	<b>8.2</b>	<b>34.7</b>

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