

Zenabis Global Inc.^{1,7}

BUY

ZENA-TSX

August 14, 2019

 Last: **C\$1.47**
 Target: **C\$3.25**

Q2: Cannabis sales up 78% QoQ with flat OPEX

Summary: ZENA reported Q2 results that were slightly below our expectations but still showing strong growth. The company also increased its guidance for annual production capacity by 35%. Total gross revenue was \$26.5mm vs. our expectations of \$27.8mm, including \$7.3mm in net cannabis revenue, up 78% QoQ. ZENA mentioned a strategy of lowering prices to obtain greater REC market share, along with some logistical issues, where it had more optimistic expectations for cannabis sales in Q2. The strategy has early indication of working with ZENA taking #1 market share recently by volume in Nova Scotia and New Brunswick. Q2 Adj. EBITDA of (\$6.3mm) in the quarter compared to our estimate of (\$5.5mm) and it was encouraging to see flat OPEX. Overall, ZENA appears to be on the path to meet our expectations, while the capital structure continues to be cleaned up. We are also comforted by the exceptional partner feedback received on ZENA, giving us conviction on the name. ZENA continues to trade well below most peers at ~7x 2020 EBITDA. **BUY.**

Opportunity to become a top five LP: ZENA now has licensed production capacity of 54,000 kg and a goal to increase capacity further to 143,200 kg in 2019 with construction and licensing progressing at its Langley facility. ZENA expects the cultivation cost per gram to be \$0.50 at Langley and the Atholville facility was disclosed as \$0.78 in cost, down \$0.32 in Q2. Continued outperformance in production and lowered cultivation costs should lead to significant value creation. Also, the expansion ahead could position ZENA as a top five Canadian LP supplier with one of the lowest production costs. Although, most LPs have aggressive expansion plans, our ZENA forecasts reflect conservatism to what it is capable of achieving with Dutch horticultural expertise. We are also comforted with the fact that ZENA's partner ecosystem is highly supportive and a strong entrepreneurial team will be flexible in pricing to move high quality product.

Propagation business supports value creation with added stability: As part of the creation of ZENA, Bevo Agro and SunPharm merged through an RTO deal in Jan. 2019. Bevo is a plant propagation business (seed to seedling) that has monopolistic characteristics, good growth and a history of value creation. Bevo will contribute ~\$35m in sales and ~\$8m in EBITDA with what we estimate to be ~\$100m in EV to ZENA. This also highlights a low EV of ~\$200m attributed to cannabis or ~7x multiple vs. peers at ~20x, in part from a complicated capital structure. However, most dilutive ZENA securities have much higher strike prices and the capital structure is in the process of being cleaned up.

Rating: Our \$3.25 target is based on a 12x EBITDA multiple for propagation and 15x for cannabis. We see ZENA as becoming a top five Canadian LP supplier. **BUY.**

Prepared by GMP Securities L.P.

What's Changed	Old	New
Rating	BUY	n.c
Target	\$3.25	n.c
Revenue 2018A (m)	\$7.0	n.c
Revenue 2019E (m)	\$100.1	\$95.4
Revenue 2020E (m)	\$261.6	\$262.1
EBITDA 2018A (m)	(\$13.9)	n.c
EBITDA 2019E (m)	(\$9.4)	(\$19.2)
EBITDA 2020E (m)	\$51.5	\$51.1

Share Data

Share o/s (m, basic/f.d.)	203.8 / 248.5
52-week high/low	6.85 / 1.38
Market cap (basic, m)	\$300
Market cap (f.d., m)	\$365
Net debt (m)	\$33.0
Net debt (f.d., m)	(\$25.6)
EV (f.d., m)	\$340
Projected return	121.1%

Financial Data

FYE Dec 31	2018A	2019E	2020E
Revenue (m)	\$7.0	\$95.4	\$262.1
EBITDA (m)	(\$13.9)	(\$19.2)	\$51.1
EV/EBITDA	nmf	nmf	6.6x
EPS (f.d.)	(\$0.16)	(\$0.19)	\$0.06
P/E	nmf	nmf	23.4x
CFPS	(\$0.13)	(\$0.17)	\$0.15
P/CF	nmf	nmf	9.8x
Net debt (m)	\$18.4	\$111.6	\$124.3
BVPS	\$0.23	\$0.64	\$0.67
P/BV	6.5x	2.3x	2.2x

All figures in C\$ unless otherwise noted

 Current Chart

 Previous Research

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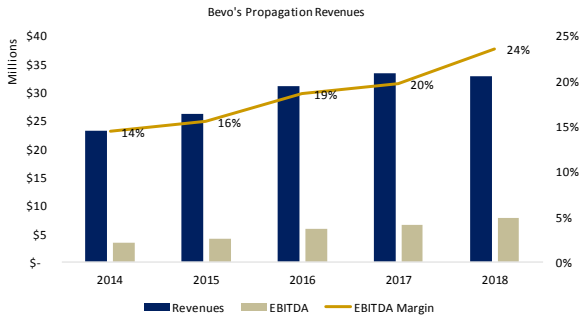
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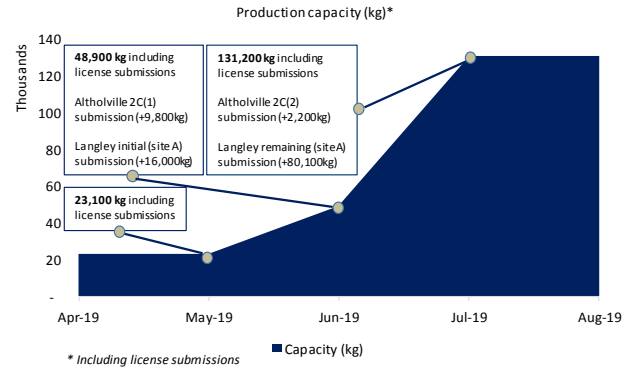
Figure 1. Key trends

Bevo has a history of value creation ...

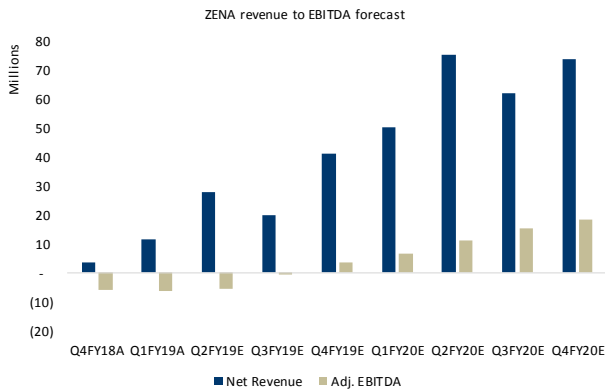


Sources: Zenabis Global, GMP Securities

Capacity is ramping up ...



Our forecasts reflect a conservative utilization rate



Sources: Zenabis Global, GMP Securities

And ZENA valuation is below most peers.

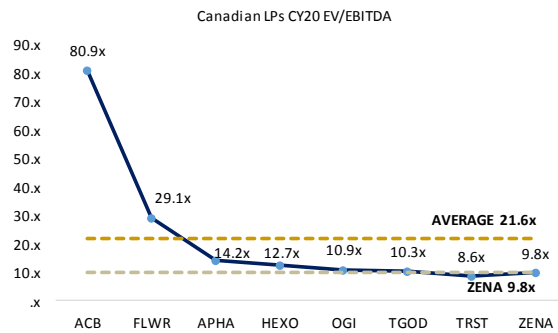


Figure 2. Q2 results summary table

Year-end Dec-31 (C\$)	Q2/19A	Q1/19A	Chg. QoQ	GMP	
				Q2/19E	Diff
Avg net selling price (\$/gram)	\$4.22	\$5.92	-29%	\$5.03	-\$0.81
# of Grams sold	1,720,262	692,356	148%	2,027,000	(306,738)
Net cannabis revenues	7,251,860	4,098,973	77%	10,195,750	(2,943,890)
Propagation revenues	18,128,001	7,206,389	152%	17,617,647	510,354
Other revenues	(330,152)	251,855	-231%	-	(330,152)
Total revenues	25,049,709	11,557,217	117%	27,813,397	(2,763,688)
Adj. COGS	16,665,942	7,680,343	117%	17,906,603	(1,240,661)
Adj. gross profit	8,383,767	3,876,874	116%	9,906,794	(1,523,027)
Gross profit margin	33.5%	33.5%	-8bps	35.6%	-215bps
General and administrative	2,928,728	2,600,001	13%	5,562,679	(2,633,951)
% of sales	11.7%	22.5%	-1081bps	20.0%	-831bps
Salaries and benefits	6,071,029	3,869,419	57%	8,344,019	(2,272,990)
% of sales	24.2%	33.5%	-924bps	30.0%	-576bps
Professional fees	3,478,064	2,168,120	60%	1,493,118	1,984,946
Other	2,202,281	1,665,050	32%	-	2,202,281
Share based compensation	2,142,433	2,078,636	3%	2,102,101	40,332
Depreciation & amortization	2,102,987	1,462,077	44%	2005337	97,650
Operating income	(10,541,755)	(9,966,429)	6%	(9,600,460)	(941,295)
Interest expense	3,751,166	4,553,288	-18%	1,682,029	2,069,137
Finance & investment expense	98,557	(1,116,320)	-109%	-	98,557
EBT	(14,391,478)	(13,403,397)	7%	(11,282,490)	(3,108,988)
Income tax expense	1,547,119	(1,841,977)	-184%	(3,384,747)	4,931,866
Adjusted net income	(15,938,597)	(11,561,420)	38%	(7,897,743)	(8,040,854)
Adjusted EPS (f.d.)	(0.08)	(0.06)	28%	(0.03)	(0)
Shares outstanding, diluted	200,917,624	186,777,479	8%	248,257,450	
Adj. EBITDA	(6,296,335)	(6,425,716)	-2%	(5,493,022)	(803,313)

Sources: Zenabis Global, GMP Securities

Summary of changes to our forecasts

Year-end Dec-31 (C\$, '000)	FY18A		FY19E		FY20E	
	New	Old	New	Old	New	Old
Revenues	6,986	6,986	95,370	100,084	262,144	261,608
EBITDA	(13,874)	(13,874)	(19,184)	(9,359)	51,130	51,518
EBITDA margin %	-198.6%	-198.6%	-20.1%	-9.4%	19.5%	19.7%
EPS (f.d.)	-\$0.16	-\$0.16	-\$0.19	-\$0.12	\$0.06	\$0.06

Sources: Zenabis Global, GMP Securities

Investment thesis

We see ZENA as becoming a top five Canadian LP with its shares substantially undervalued at ~7x EBITDA, in part from a complicated capital structure that is being cleaned up. We spoke to several of ZENA's partners, including government contacts at the distribution level in different provinces and the feedback was unanimously positive. Contacts described ZENA's quality of operations as one of the best when compared to other LPs and spoke to the high ethics of management and solid relationships in place. This bodes well in an industry going through rapid transition, where we see competitive advantages in high quality producers with strong reputations and partnerships. We are also comforted with the strength of ZENA's team at multiple levels, including the founders, management and growers. The hands-on team is well aligned at ~53% insider ownership and generally have entrepreneurial backgrounds with multiple successes in a variety of industries. ZENA will also be flexible on pricing to move a high-quality product, important in our view as the industry matures.

Partner feedback and scuttlebutt

We try to differentiate our research by speaking to as many customers, industry experts and contacts that we can about a company. Each process is unique, depending on the industry and market dynamics but we find that this type of primary research helps us in better understanding businesses and ultimately picking good stocks. Cannabis presented challenges in our research process as a relatively new industry with a very broad set of customers. We therefore focused on reaching out to ZENA's distribution partners and government contacts familiar with the company and operations. This level of research is far more encompassing than our own opinions and we were very encouraged, given the exceptional feedback received on ZENA. We highlight our key findings:

Quality facilities: We were told that ZENA "passed with flying colours" in regards to the quality of facilities. One partner said that the facilities are far beyond the requirements put forth by Health Canada, important for the medical business. A government contact also said that quality facilities usually lead to quality products and is an important criteria in determining who to request supply from.

Best in class operators: Our contacts all spoke of how great it was to work with the ZENA team, including several government contacts. Feedback included that ZENA was "very easy to work with", "has high integrity", "receptive to feedback", "willing to find solutions" and "quick to respond". One contact simply said "amazing experience". We put high weight in this type of feedback as it should lead to long-term benefits in an industry going through rapid transition, where all companies may not survive. We also heard of less favourable feedback for other LPs, including that some seem to only be "focused on their stock price" and not product quality.

Innovation: One large commercial partner told us that part of the reason for selecting ZENA was its ability and history of innovation with Bevo. In what seems like a simple business, Bevo has had substantial innovations in its growing processes and automation. A good example of this was the spin out of a proprietary vertical farming technology, now commercialized by CubicFarm Systems that had a ~\$100m valuation. ZENA has extraction technology on-site and is investing in considerable R&D capabilities with several PhD resources.

Capacity to expand: Most partners also mentioned that it was important to see the expansion capability when selecting preferred suppliers. ZENA expects to expand production to 143,200 kg this year, supporting this criteria.

Product quality: We heard good feedback on ZENA's quality of products and growing practices. Partners mentioned that ZENA had superior growing methodologies, which may be in part from its food expertise with Bevo. There were also no concerns mentioned for the types of products used in ZENA's growing process. One contact referred to ZENA's offering as a "premium product", supported by online end customer reviews.

How we buy: A government contact spoke to reasons for selecting certain LPs and supply that include the track record of meeting sales goals, customer pull-through, willingness to drop price to not take up inventory and general receptiveness and ability to problem solve. ZENA was again rated very high for this criteria and one of the best when compared to other LPs.

What to avoid: We were told of certain unethical practices that take place in the cannabis industry, which is not unexpected, given the recent legal transition. Our partner contacts said that they are aware of LPs that don't operate with high integrity and ethics, and limit or avoid these companies. ZENA was consistently mentioned as a company with the highest ethical considerations and as having strong partnership relationships. We believe that this is critical to having good business values and helps us navigate which stocks are good investments.

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