

Cronos Group

(MJN-T: C\$2.08)

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BUY

Target: C\$4.00 (from C\$2.25)

Ramping Faster With Exposure To Germany

MJN-T	New	Last
Rating:	--	BUY
Target:	4.00 ▲	\$2.25
Projected Return:	92%	8%
F2021 EBITDA (MM\$)	\$113 ▲	\$61
Target multiple:	--	7.0x

Company Data		
Price (1/10/17):		\$2.08
52-Week Range (H-L):	\$2.23	\$0.14
Market Capitalization (MM\$):		\$249
Enterprise Value (MM\$):		\$250
Shares Outstanding - Basic (MM):		119.6
Shares Outstanding - Diluted (MM):		169.8
Avg Daily Volume (3 Mos) (000s):		506
Cash (MM\$):*		\$5.80
Debt (MM\$):		\$6.60
Working Capital (MM\$):		\$1.55
Fiscal Year End		March

Forecasts (Dec YE)	2016E	2017E	2018E
Price per gram (\$/g)	7.50	7.50	7.50
COGS (\$/g)	2.99	2.74	2.74
Revenue (MM\$)	0.8	8.5	73.3
EBITDA (MM\$)	(2.0)	(3.4)	9.5
EPS (\$/sh)	-0.07	-0.06	0.05
OP CF (MM\$)	(6.2)	(7.4)	(4.5)
CF/share (\$/sh)	-0.12	-0.10	-0.05
Capex (MM\$)	(0.4)	(10.3)	(36.0)
FCF (MM\$)	(6.6)	(17.7)	(40.5)

All Figures in C\$ Unless Otherwise Noted

Source: FactSet, Company Reports, Eight Capital

MJN: Price/Volume Chart



Source: Factset

Company Description

Cronos owns two LPs (one in Ontario and one in BC) and has minority interests in three others. Cronos has two unique initiatives: a distribution agreement in Germany and a JV with First Nations in Canada.

Last week we toured the indoor facilities at Peace Naturals, one of Cronos' two wholly owned licenses, in Stayner, ON. We have increased confidence in Cronos' rollout of its expansion plans following discussions with management and we have accelerated the timing of multiple buildouts compared to our previous assumptions. Also, with Germany recently legalizing medical cannabis ([link to our industry comment](#)) we now include sales to Germany in our estimates. As a result, our target increases due to the increase in EBITDA in our valuation year.

Geographic and brand diversity distinguishes Cronos from its peers. Cronos is one of only three multi-LP enterprises, and is the only one holding licenses in two different provinces: Peace Naturals Project (Peace) in Ontario and In The Zone Produce (ITZ) in British Columbia. Cronos has established two unique partnerships including a distribution agreement with German-based pharmaceutical distributor Pedanios for export of PNP cannabis products, and a profit-sharing JV at ITZ with a First Nations group Indigenous Roots for facility construction and sale of product to an underserved patient population.

We now model Cronos expanding its built capacity from 4,500 kg to 50,000 kg (previously 25,000 kg) over the next four years. The expansions include:

- **Peace Naturals** - Peace currently has three indoor buildings with 4,500 kg of production capacity. A small greenhouse will be constructed behind the indoor facilities for the purpose of extracts production. The next major phase of expansion will see the construction of a 220,000 sq ft greenhouse facility capable of ~25,000 kg of annual production, providing much of the increase to our estimates. We note a portion of the expansion capacity will be allocated to its German partner for distribution to German patients.
- **In The Zone** - ITZ currently operates in a small 2,500 sq ft indoor pilot facility with ~100 kg of annual production. The next phase is construction of a 100,000 sq ft greenhouse capable of ~10,000 kg per year.
- **Indigenous Roots** - A unique partnership with this First Nations group will see the construction of a purpose built 30,000 sq ft indoor production facility capable of ~4,000 kg per year - paid for entirely by Cronos' partner - with Cronos splitting 50% of the net operating profit from the facility. We note this profit sharing agreement carries over for other new facilities that may be built in the future.

Including sales to Germany in our new estimates. Last month the German parliament [voted to legalize medical cannabis](#), but there is no production infrastructure. There are currently only ~1,000 patients that have been granted access to use cannabis, patients are likely to be covered by health insurance plans and it is distributed in pharmacies. Over time we suspect Cronos will invest in building production capacity in Germany as well.

We are maintaining our BUY rating and increasing our price target to \$4.00 (from \$2.25) based on a 7.0x EV/EBITDA multiple on our FY2021E EBITDA of \$113MM (from \$61MM). We believe the rec regime would be in place for three years by that time, and is a more relevant time period to value the industry's potential. The 7.0x multiple is in the middle of our peer group range of 4.0x - 10.0x, due to Cronos' multi-license platform and international partnerships. MJN trades at 2.2x our FY2021E EBITDA (peers at 3.8x)

Capacity and room for expansion across the two flagship assets. Cronos' domestic efforts are focused on expanding operations at both of its wholly-owned properties. Peace is located on over 90 acres of land currently with three production buildings, and the ITZ pilot facility is located on 31 acres of land while ongoing engineering and design work is progressing for the expansion. As of Sept 30, 2016 Cronos reported \$5.8MM cash and \$6.6MM debt. As for most LPs, we generally model \$10MM needed for a 10,000 kg capacity expansion. We model Cronos now raising \$80MM (previously \$60MM) over the next three years (previously five) to expand capacity across its entire platform, with the added \$20MM for construction of a production facility in Germany. We assume an average financing price of \$3.00 (previously \$2.25).

Figure 1 - Facility Overhead View of Peace Naturals (left) and In The Zone (right)



Source: Company Presentation

EXPORTING TO GERMANY FROM PEACE NATURALS

Peace exports to Germany through Pedanios GmbH. On October 11, 2016, Cronos announced the first shipment of medical cannabis dried flowers had been [exported from Peace to Germany](#) through a co-brand supply agreement with new partner Pedanios GmbH, a licensed wholesaler and importer connected to one of Germany’s largest networks of pharmacy customers. In December 2016, Cronos affirmed this relationship by signing an [exclusive supply agreement](#). German regulations currently only allow distribution but not production within the country. Pedanios holds one of a limited number of medical cannabis business licenses in Germany, and currently distributes Germany’s limited medical cannabis supply to a network of over 200 pharmacies. The authorization for export included five varieties of medicinal cannabis flowers, namely Pedanios 22/1 and Pedanios 14/1 (THC/CBD ratios).

A key addition to our estimates would be the construction of 20,000 kg annual capacity production facility in Germany, which we estimate will operate at (and sell) 25% of capacity in 2019, 50% in 2020, 75% in 2021, and 100% thereafter - we believe the German medical market is around 2-3 years behind Canada. We have limited visibility on Cronos' construction timelines there, but Cronos can export product to Germany until such time it builds a facility, applies for a license, receives a license, and cultivates/harvests/cures product ready for sale. We assume product is sold in Germany for \$7.50/gram with a ~45% gross margin which includes a distributor margin to Pedanios.

We estimate the German market is valued at 2.5x our estimate of a \$3B Canadian medical market. We assume the long term penetration rate of medical patients in Canada reaches 2% of the total population by 2024 (~800,000 patients) equating to a \$3.0B medical market that same year. The penetration rate is comparable to similarly aged existing programs in other countries, though new frameworks must be in place to unlock the full potential of the industry here. Our \$3.0B flower & extracts medical market assumes 50% of patients exclusively purchase flower and 50% of patients exclusively purchase extracts; we assume no cross-selling though it is likely. We assume each flower patient consumes 1.0 gram/day at \$7.50/gram and each extract patient consumes 1.0 gram(eq)/day at \$15.00/gram(eq). Though the oil and extract market is relatively young, we assume medical innovation brings development and commercialization of value-added formulation and delivery devices for cannabis therapeutics which may support our longer term pricing assumption in this segment.

Figure 2 - International Medical Markets Provide Material Opportunities For LPs

	Australia	Brazil	Croatia	Germany	Israel	Netherlands	Average	Total	Canada
Population (MM)	23.1	200.4	4.3	80.6	8.1	16.8	55.5	333.3	35.2
Potential MMJ patients (MM) 2% of population	0.5	4.0	0.1	1.6	0.2	0.3	1.1	6.7	0.8
Est. MMJ market size (\$MM)* 50% flower only @ \$7.50/day 50% extract only @ \$15.00/day	\$1,857	\$16,092	\$342	\$6,474	\$647	\$1,349	\$4,460	\$26,761	\$3,000

*Based on DCP's estimates for Canada

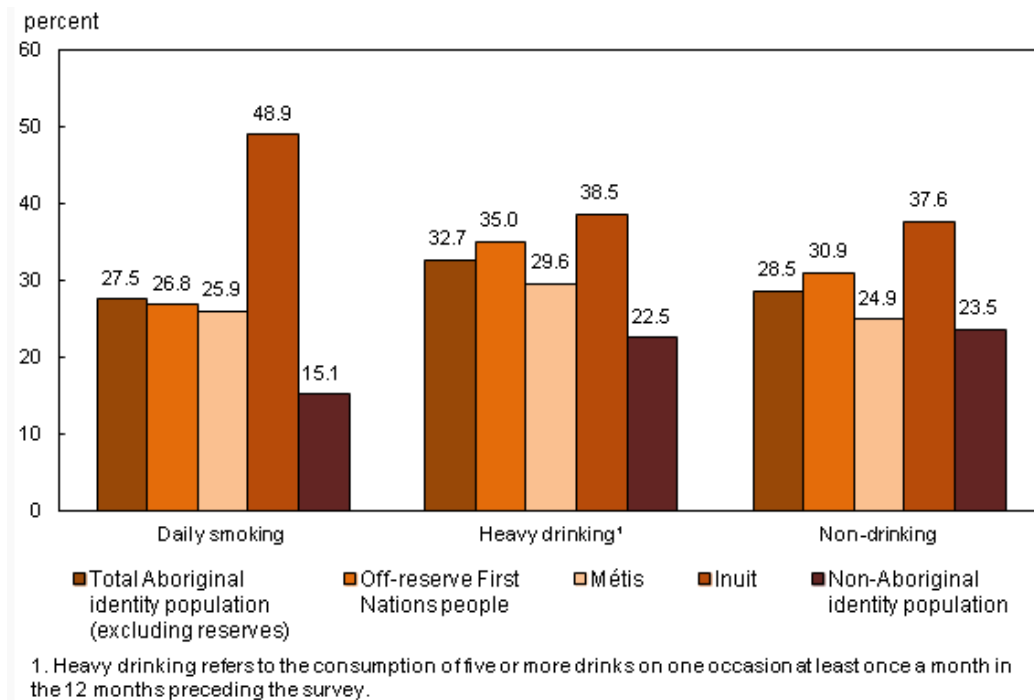
Source: Eight Capital Estimates

CARVING OUT LAND ON ITZ FOR INDIGENOUS ROOTS JOINT VENTURE

Native Canadian JV with 'Indigenous Roots' to build a facility on ITZ land. On the home front, on December 6, 2016, Cronos announced the launch of a [first-of-its-kind joint venture with Indigenous Roots](#), a Canadian First Nations medical cannabis company that will finance the building and operation of a production facility for the sale of cannabis to First Nations patients. Under the agreement, Cronos will provide the land, license, IP, and engineering expertise for the new facility and ongoing training for the First Nations staff, in exchange for a 50% share of the operating profits. This JV does not affect the current or future production at ITZ since the JV will only operate on a portion of ITZ's land.

Indigenous Roots is led by Phil Fontaine, former National Chief of the Assembly of First Nations, who intends to consult and work cooperatively with First Nations that are interested in participating, and may seek to source and license additional facilities on First Nations' reserves, ultimately pursuing an international presence. The newly formed entity will commit to remaining a First Nations owned and operated company providing employment and economic opportunities to First Nations people.

Figure 3 - Over 27% of Aboriginal People In Canada Reported Smoking Daily



Source: StatsCan (2012)

The First Nations population is already inclined to smoke. There are approximately 1.5MM First Nations people in Canada and data shows that this population already has a tendency to smoke. A 2012 StatsCan [survey of First Nations](#) populations in Canada found that 27% of off-reserve First Nations people age 12 and over reported smoking daily.

Their unique situation likely qualifies for medical cannabis reimbursement, potentially making them a high value, sticky patient population. The [First Nations and Inuit Health Branch](#) supports the delivery of public health services to First Nations and Inuit people including drug, dental, and ancillary health services, as well as primary care services in remote and isolated areas where no provincial services are readily available. One of the programs within the Branch is the [Non-Insured Health Benefits \(NIHB\) Directorate](#), which provides to registered First Nations and recognized Inuit supplemental coverage for a range of medically necessary health related benefits including prescription and OTC drugs, dental and vision care, mental health counselling, medical equipment, supplies, and transportation. Though medical cannabis currently is not classified under the [NIHB First Nations and Inuit Health Drug Benefit List \(2016\)](#), we believe that it could qualify for [pharmacy and drug reimbursement](#) because the prescriber must be a physician or licensed health practitioner (currently like cannabis under the ACMPR) and the patient can take their prescription to any licensed pharmacy to be filled (which we expect will be a distribution model under the new recreational regulations).

We believe Cronos is well positioned to benefit from a large and untapped patient population that, in our view, has a good chance at receiving insurance coverage. In [November 2016](#), Veteran's Affairs Canada limited the reimbursement to the Veteran patient population to 3 grams/day and \$8.50/gram citing [escalation in program costs](#). Using comparable metrics and assuming (1) 25% penetration and (2) each patient acquires the full 3 gram/day allotment, we estimate the First Nations market in Canada is worth \$3.5B (!) in annual revenue alone.

Figure 4 - Health Canada Licensed Producer (LP) Comp Table

All in CAD\$	Ticker	Rating	Target	Last \$/sh	S/O MM	FD S/O MM	Mkt Cap \$MM	Cash \$MM	Debt \$MM	EV \$MM	LSC kg	EV/LSC \$/g	EV/EBITDA			EV/Sales		Performance		
													CY2016	CY2017	FY2021	CY2016	CY2017	1mo	3mo	6mo
Aphria	APH-T	B	\$7.50	\$5.50	123.1	133.5	\$677	\$155.0	\$7.0	\$529	2,800	189	161.7x	61.7x	4.7x	29.8x	16.3x	-4%	20%	100%
Aurora Cannabis	ACB-C	R		\$2.55	318.5	354.9	\$811	\$125.0	\$22.4	\$709	2,500	283	--	--	--	--	--	1%	24%	282%
Beleave Inc.	BE-C	B	\$1.80	\$1.71	21.4	33.9	\$37	\$1.4	\$0.0	\$35	--	--	NM	NM	2.0x	NM	NM			
CanniMed	CMED-T			\$12.00	19.7	24.5	\$236	\$65.0	\$20.0	\$191	3,000	64	--	--	--	--	--			
Canopy Growth	WEED-T	B	\$14.00	\$12.40	154.3	166.5	\$1,913	\$126.0	\$11.1	\$1,798	19,100	94	652.5x	148.2x	7.5x	56.9x	17.9x	27%	37%	199%
Cronos Group	MJN-T	B	\$4.00	\$2.08	119.6	169.8	\$249	\$5.8	\$6.6	\$250	2,744 ²	91	NM	NM	2.2x	NM	29.3x	11%	82%	333%
Emblem Group	EMC-T	B	\$4.75	\$3.65	69.6	117.5	\$254	\$40.0	\$5.5	\$219	625	351	NM	NM	2.8x	NM	39.9x			
Emerald Health	EMH-T	B	\$1.75	\$1.36	87.0	106.9	\$118	\$17.5	\$0.0	\$101	150	673	NM	NM	2.9x	66.2x	66.2x	-8%	66%	346%
MMJ Phytotech	MMJ-AU	R		\$0.29	141.1	164.3	\$41	\$1.9	\$0.5	\$40	--	--	--	--	--	--	--	38%	38%	12%
OrganiGram	OGI-T	B	\$4.50	\$2.70	100.9	111.8	\$272	\$60.0	\$3.3	\$216	1,200	180	407.8x	95.2x	3.3x	29.4x	11.8x	-3%	-1%	59%
Supreme Pharma	SL-C	B	\$2.00	\$1.78	160.9	315.0	\$286	\$16.0	\$59.0	\$329	100	3,292	NM	NM	5.3x	NM	14.8x	5%	40%	253%
THC BioMed	THC-C			\$0.80	96.2	114.8	\$77	\$1.0	\$0.8	\$76	--	--	--	--	--	--	--	-10%	-1%	335%
Average (n = 13)							\$414	\$51.2	\$11.3	\$374	3,580	580	407.4x	101.7x	3.8x	45.6x	28.0x	9%	34%	213%
Median													407.8x	95.2x	3.1x	43.3x	17.9x	3%	37%	253%

¹ Estimates are Eight Capital's; adjusted for calendar year-ends

² Attributable based on equity ownership of LP's

LSC = Licensed Sales Capacity; B = Buy; N = Neutral; R = Restricted; UR = Under Review

Source: FactSet, Eight Capital

Cronos Group (MJN-T)

Rating	BUY	C\$ Target	\$4.00	Shares O/S (MM)	119.6
		C\$ Close	\$2.08	Fully Diluted Shares (MM)	169.8
Daniel Pearlstein, Research Analyst		12-month return	92%	Basic Mkt. Capitalization (\$MM)	\$248.7
dpearlstein@viiccapital.com				Enterprise Value (\$MM)	\$249.5

VALUATION DATA

Year-end December	2015A	2016E	2017E	2018E
P/E	64.2x	--	--	45.3x
P/CF	--	--	--	--
EV/EBITDA	--	--	--	26.2x
EV/Sales	--	306.3x	29.3x	3.4x
FCF Yield	--	--	--	--

OPERATING STATS

Year-end December	2015A	2016E	2017E	2018E
Total Bud Sales (kg)	0	100	945	7,906
Price Per Gram (\$/g)	--	7.50	7.50	7.50
COGS (\$/g)	--	2.99	2.74	2.74
Total Oil Sales (kg)	--	4	94	526
Price Per Gram (\$/g)	--	15.00	15.00	15.00
Oil Gross Margin	--	50%	50%	50%

FINANCIAL SUMMARY

Year-end December	2015A	2016E	2017E	2018E
Revenue (MM\$)	0.0	0.8	8.5	73.3
Gross Profit (MMS)	0.5	0.6	5.2	34.7
Gross Margin	--	75%	61%	47%
EBITDA (MM \$)	(2.1)	(2.0)	(3.4)	9.5
EBITDA Margin	--	--	--	13%

CRONOS VALUATION (C\$)

	Target Price	Upside
7.0x EV/EBITDA Multiple on F2021	C\$4.00	92%

Target Price Sensitivity

F2021E EV/EBITDA	F2021 EBITDA (C\$MM)				
	\$90.0	\$100.0	\$113	\$120.0	\$130.0
5.0x	\$2.25	\$2.50	\$2.75	\$3.00	\$3.25
5.5x	\$2.50	\$2.75	\$3.00	\$3.25	\$3.50
6.0x	\$2.75	\$3.00	\$3.50	\$3.50	\$4.00
6.5x	\$3.00	\$3.25	\$3.75	\$4.00	\$4.25
7.0x	\$3.25	\$3.50	\$4.00	\$4.25	\$4.50
7.5x	\$3.50	\$3.75	\$4.25	\$4.50	\$4.75
8.0x	\$3.50	\$4.00	\$4.50	\$4.75	\$5.25
8.5x	\$3.75	\$4.25	\$4.75	\$5.00	\$5.50
9.0x	\$4.00	\$4.50	\$5.00	\$5.25	\$5.75

BALANCE SHEET (C\$ MM)

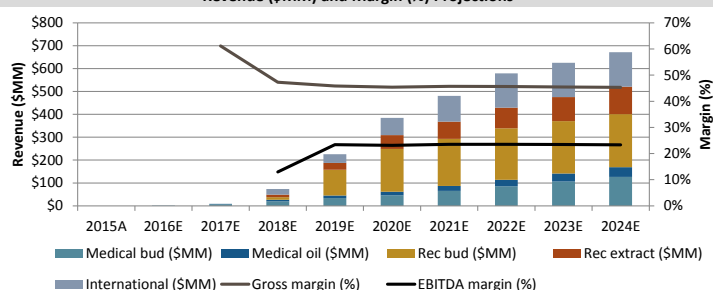
Year-end December	2015A	2016E	2017E	Q3/16
Assets:				
Cash & ST Investments	1.1	4.1	6.8	5.8
Other Current Assets	0.1	3.9	8.5	3.4
Current Assets	1.2	8.0	15.3	9.2
PP & E	2.7	13.1	22.5	12.9
Other non-current Assets	10.8	17.6	18.2	17.5
Total Assets	14.7	38.7	55.9	39.6
Liabilities:				
Current Liabilities	2.3	7.7	1.9	7.6
Long-term Debt	0.0	0.0	0.0	0.0
Other non-current Liabilities	0.7	1.4	1.9	1.4
Total Liabilities	3.0	9.2	3.7	9.0
Capital Stock	16.7	38.2	65.2	38.2
Retained Earnings	-5.0	-8.6	-13.0	-7.6
Total Shareholder Equity	11.7	29.5	52.2	30.6

INCOME STATEMENT (C\$ MM)

Year-end December	2015A	2016E	2017E	2018E
Total Revenue	0.0	0.8	8.5	73.3
COGS	-0.5	0.2	3.3	38.7
Gross Profit	0.5	0.6	5.2	34.7
G&A	1.7	1.9	4.2	14.5
Sales & Marketing	0.0	0.4	4.1	10.5
Depreciation	0.1	0.3	0.9	3.4
EBITDA	(2.1)	(2.0)	(3.4)	9.5
EBIT	(2.2)	(2.3)	(4.2)	6.1
Interest Expense/Income	0.0	0.2	0.1	0.0
EBT	-2.2	-2.6	-4.3	6.1
Taxes	-0.2	-0.2	0.0	1.9
Other	3.4	-0.9	0.0	-3.7
Net Income (Reported)	1.0	-3.6	-4.3	4.2
EPS (Reported) \$/sh	0.03	-0.07	-0.06	0.05
Average Shares (MM)	32.2	53.5	75.8	92.4

CASH FLOW STATEMENT (C\$ MM)

Year-end December	2015A	2016E	2017E	2018E
Net Income (Reported)	0.4	(3.6)	(4.3)	4.2
Depreciation	0.1	0.3	0.9	3.4
Working Capital Changes	0.6	(3.3)	(3.4)	(11.5)
Other	(2.5)	0.4	(0.5)	(0.6)
Operating Cash Flow	(1.4)	(6.2)	(7.4)	(4.5)
Operating Cash Flow/sh (\$/sh)	-0.04	-0.12	-0.10	-0.05
Capital Expenditures	(1.5)	(0.4)	(10.3)	(36.0)
Other	0.1	(6.9)	0.0	0.0
Investing Cash Flow	(1.5)	(7.3)	(10.3)	(36.0)
Common Share Dividends	0.0	0.0	0.0	0.0
Equity financing & W/O Exercise	2.0	21.0	30.0	40.0
Debt Issue	0.0	0.0	0.0	0.0
Debt Repayment	0.0	(2.7)	(4.0)	0.0
Other	1.2	(1.8)	(5.6)	(4.0)
Financing Cash Flow	3.2	16.5	20.4	36.0
Net Change in Cash	0.3	2.9	2.8	(4.5)
Cash Balance	1.1	4.1	6.8	2.4
Free Cash Flow	(2.9)	(6.6)	(17.7)	(40.5)

Revenue (\$MM) and Margin (%) Projections

Source: Company Reports, FactSet, Eight Capital

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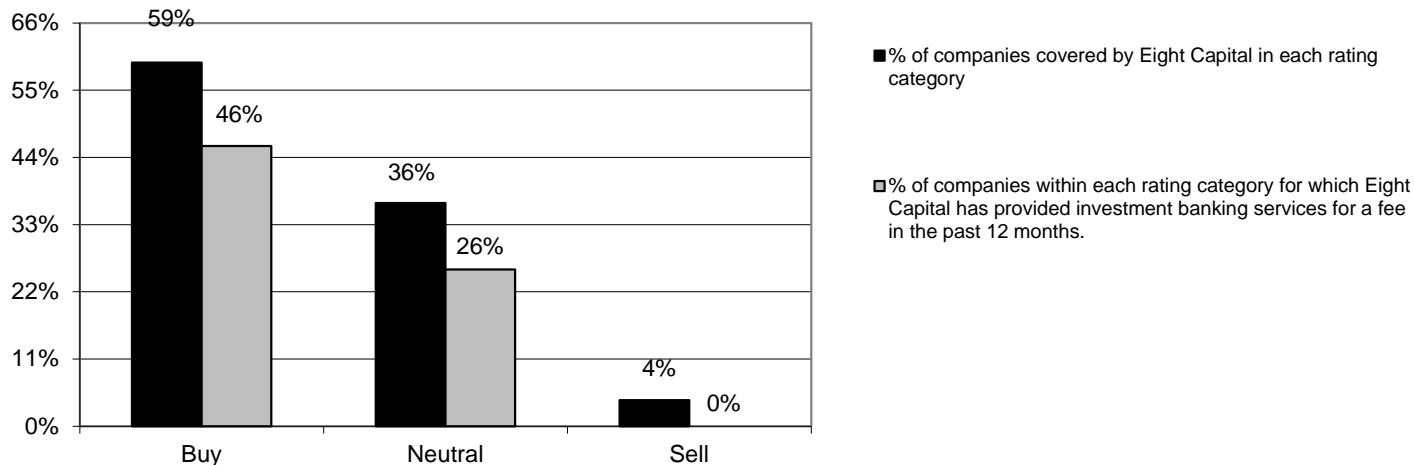
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Eight Capital target: Represents the price target as required under IIROC Rule 3400. Valuation methodologies used in determining the price target(s) for the issuer(s) mentioned in this research report are contained in current and/or prior research. Eight Capital target N/A: a price target and/or NAV are not available if the analyst deems there are limited financial metrics upon which to base a reasonable valuation.

Recommendations: **BUY:** Total returns expected to be materially better than the overall market with higher return expectations needed for more risky securities. **NEUTRAL:** Total returns expected to be in line with the overall market. **SELL:** Total returns expected to be materially lower than the overall market. **TENDER:** The analyst recommends tendering shares to a formal tender offer. **UNDER REVIEW:** The analyst will place the rating and/or target price Under Review when there is a significant material event with further information pending; and/or when the analyst determines it is necessary to await adequate information that could potentially lead to a re-evaluation of the rating, target price or forecast; and/or when coverage of a particular security is transferred from one analyst to another to give the new analyst time to reconfirm the rating, target price or forecast.

SECURITY ABBREVIATIONS: NVS (non-voting shares); RVS (restricted voting shares); RS (restricted shares); SVS (subordinate voting shares).

Eight Capital Equity Research Ratings:



As at December 31, 2016
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