Sundial Growers Inc.

Full Year and Fourth Quarter 2021

Financial Results Conference Call Transcript

Date: **Thursday, April 28, 2022**

Time: **8:30 AM MT**

Speakers: **Zach George**
Chief Executive Officer

Jim Keough
Chief Financial Officer

Andrew Stordeur
President and Chief Operating Officer

Operator:
Good morning, and welcome to Sundial Growers Full Year and Fourth Quarter 2021 Financial Results Conference Call.

Yesterday Sundial issued a press release announcing their financial results for the full year and fourth quarter ended on December 31, 2021. This press release is available on the Company's website at sndlgroup.com, and files on EDGAR and SEDAR as well. The webcast replay of the conference call will also be available on the sndlgroup.com website. Sundial has also posted a supplemental investor presentation on its website, and a letter to shareholders from Sundial CEO Zach George. Both can be found on the sndlgroup.com website.

Presenting on this morning's call, we have Zach George, Chief Executive Officer; Jim Keough, Chief Financial Officer; and Andrew Stordeur, President and Chief Operating Officer.

Before we start, I would like to remind investors that certain matters discussed in today's conference call, or answers that may be given to questions, could constitute forward-looking statements. Actual results could differ materially from those anticipated. Risk factors that could affect results are detailed in the Company's financial reports and other public filings that are made available on SEDAR and EDGAR.

Additionally, all financial figures mentioned are in Canadian dollars unless otherwise indicated.

We will now make prepared remarks, and then we will move on to analysts' questions.

I would now like to turn the call over to Zach George.

Zach George:
Good morning, everyone, and thank you for joining us on our Full Year and Fourth Quarter 2021 Earnings Call.

Twenty Twenty-one was a transformational year for Sundial. Our team has taken Sundial from a position of financial distress to achieving sequential records for Adjusted EBITDA for the last two reported quarters. We ended 2021 with no outstanding debt and $1.1 billion between cash, marketable securities, and long-term investments. We still have significant work ahead and are focused on continuous improvement in all areas of our business.

Sundial is working to become a leading regulated products platform by leveraging consumer insights and innovation to deliver best in class products.

Sundial has the financial and operational scale to be a legitimate contender to build and own a meaningful relationship with the Canadian consumer.

We are beginning to see positive momentum across most of our key operating segments, and I'm excited by a few small but important wins that we are experiencing in early 2022.

We remain committed to our goal of becoming free cash flow-positive, net of investment commitments, within the 2022 Calendar Year, as we seek to create sustainable long-term value for our shareholders.

Before going further, I'd like to address Sundial's delay in reporting our filings for the year ended December 31, 2021. The principal reason for the delay is the significant amount of additional work and in-depth procedures required to be performed by Sundial and its external auditor, as 2021 is the first year that we were required to have an auditor at the station of our internal controls over financial reporting under Section 404(b) of the Sarbanes-Oxley Act, commonly referred to as SOX.

A strong internal control environment helps optimize operations, protect cash flow, and effect good cash management policies. SOX compliance requires establishing and maintaining a strong, robust, and pervasive internal control environment for large public companies. The goal is to protect shareholders and the public from accounting errors and fraudulent practices and improve the accuracy of corporate disclosures.

The requirement to be SOX-compliant at December 31, 2021, was a function of the rapid growth in scale and level of corporate activity Sundial has achieved over the last two years. I take responsibility for this, as our corporate activity levels have placed our finance and audit teams under significant stress.

We are committed to investing in our finance functions to support the new scale and complexity of our business. SOX compliance typically takes 12 to 24 months or more for mature companies to implement, and we were required to achieve compliance in significantly less time. This work is ongoing and continuous. SOX compliance requires heightened levels of corporate controls and processes that will ultimately benefit Sundial shareholders through best practices and risk management.

Now let's turn our focus to business results.

We continue to focus on improving our supply chain and manufacturing processes in the context of Canada's competitive and challenging operating environment. We have done a comprehensive review of our portfolio to focus on our most profitable and higher-margin SKUs, which have yielded an improved gross margin.

In 2021, we saw some dramatic improvements in our cultivation results, seeing a new high water mark for weighted potency averages each sequential quarter.

In terms of our retail operations, the Spiritleaf acquisition demonstrates our commitment to owning the relationship with the consumer. In our obsession to delight consumers, we've launched a multi-store pilot program to improve the consumer experience through assortment, price, and engagement.

Year to date, our Sundial-branded share has grown in both corporate and franchise partner locations, with corporate stores leading the growth at 16.5% market share for Sundial products and franchise partner locations at 3.2%. The combined market share of 4.7% represents a 78% increase since Sundial acquired Spiritleaf in July of 2021.

I'm also excited to announce that Spiritleaf has launched a private label brand, Spiritleaf Selects. Spiritleaf has also received the 2022 franchisees' choice designation from the Canadian Franchise Association for a third consecutive year. This designation is part of the CFA's annual awards program to recognize franchising's top-performing organizations and celebrate the mutually rewarding relationship between a franchise system and its franchisees.

In 2021, Sundial deployed capital into several cannabis-related investments totalling more than $575 million, including $395 million to the SunStream Bancorp joint venture. Since SunStream was founded 12 months ago, there have been approximately 26 debt issuances, of which SunStream financed eight, or about 30%. In consideration of the larger investment opportunity, Sundial increased its commitment to SunStream to CA$538 million through July 2021. We began to explore a public offering of the portfolio to raise additional third party capital.

The nascent North American cannabis industry continues to evolve and find its way through material volatility. We have witnessed price compression, share price declines, capital access constraints, and merger and acquisition activity across the industry. We are currently seeing merger and acquisition activity impact SunStream's credit portfolio. We believe that this activity will increase the risk-adjusted returns in the portfolio, but it also creates uncertainty over the near-term construction of the portfolio, given the possibility of principal repayments. We have also seen multiple sponsors come to market with cannabis-focused financing vehicles over the last several months that have either failed or have not traded well.

These circumstances have created attractive opportunities, but have also resulted in a decision to delay the specialty finance company's previously intended initial public offering.

We are continuing to build on and benefit from the SunStream strategy and see an opportunity to help manage a $600 million to $800 million U.S. portfolio, providing Sundial with a predictable stream of income while preserving optionality to take all or a portion of the portfolio public.

Sundial's Board is keenly focused on unlocking value through the strategic positioning of this joint venture, and we expect to continue to be very active with the partnership in 2022.

With the completion of the Alcanna acquisition at the end of March, Sundial is now the largest private-sector cannabis and liquor retailer in Canada, with an industry-leading balance sheet and access to capital. Sundial can own the customer relationship while diversifying and stabilizing revenue profit streams with the addition of Alcanna. The acquisition enables Sundial to further leverage retail opportunities and become a trusted partner in the regulated product industry. We will increase our distribution in cannabis while enhancing our scale and expertise in retail operations including liquor.

Sundial has commenced and will continue the post-acquisition integration work throughout the remainder of 2022. We expect to realize significant synergies from the Alcanna transaction, and I am thrilled to be working with our new colleagues, who are steeped in retail experience.

I would also like to address the reverse share split topic once more. Sundial continues to monitor market sentiment and developments in the cannabis industry, and we are committed to the maintenance of our NASDAQ listing. If there is no significant change to market conditions, Sundial intends to implement a reverse share split in the third quarter of 2022, subject to prior shareholder approval, expected to be obtained at our 2022 annual general meeting.

Sundial is currently subject to a trading blackout period that prohibits the Company from effecting any transactions in Sundial stock, including a buyback program, until our first quarter results are released in May. Sundial did revise the consideration in the Alcanna transaction to include approximately $54 million in cash, which reduced the number of shares required to be issued, having a similar impact to a share repurchase program.

Twenty Twenty-one was an exciting, productive, and volatile year for the Sundial team, and I am pleased with the transformation we have made to position our stakeholders for long-term success. I know that I speak for the entire management team and our Board of Directors when I say that we are working hard every day to take full advantage of the opportunities at Sundial to enhance long-term shareholder value.

Thank you all, and I will now turn the call over to Jim for commentary on our financial results.

Jim Keough:
Thanks, Zach. Good morning, everyone.

I want to remind you that all amounts discussed today are Canadian dollars unless otherwise stated.

On this call, certain amounts that I will refer to are non-IFRS-GAAP measures. Please refer to Sundial's Management's Discussion and Analysis for the definitions of these measures.

I know Zach addressed the delay in filing under Canadian law for the year ended December 31, 2021, but I want to emphasize four things. First, our auditors have again issued an unqualified opinion on our financial statements. Second, our filing date complies with U.S. law. Third, we are committed to building a best in class finance department and company at Sundial. We will continue to invest in our finance and IT functions to support the growth of our business. Fourth, we are actively remediating and refining the internal control matters that we have disclosed in our reports, for the long-term benefit of our stakeholders.

So, Sundial determined that, beginning in Q1 2021, we had two reportable segments: cannabis operations and investments. With our Spiritleaf acquisition mid-year, we have expanded to include a third segment: retail operations. Now, with our exciting acquisition of Alcanna in Q1 2022, we will be adding a fourth segment: liquor retail.

Before jumping into the individual segment results, I'll start with our consolidated results of operations and Adjusted EBITDA. We're pleased that we achieved record Adjusted EBITDA from continuing operations for the Full Year 2021, with $32.1 million compared to an Adjusted EBITDA loss of $25.6 million in the previous year.

While we have made continued progress on cultivation outcomes and profitability improvements in our two cannabis segments, the increase in Adjusted EBITDA was due primarily to the introduction of our investment segment, which contributed $32.9 million from our investment in the SunStream joint venture, $13.1 million of interest in fee revenue on loans held directly by Sundial, and $20.2 million of realized gains from marketable securities sold.

Adjusted EBITDA from continuing operations for Q4 2021 was also a record at $18.4 million, compared to a loss of $5.6 million for Q4 2020.

In 2021, net loss from continuing operations was $230 million, compared to a net loss from continuing operations of $206 million for the previous year. The 2021 net loss includes $155 million of non-cash provisions, being a $60 million non-recurring impairment charge on the Olds cultivation facility, a $78 million change in estimate of the fair value of derivative warrants, and a $17 million charge for inventory impairment.

In Q4 2021, we recorded a net loss from continuing operations of $54.8 million, compared to a loss of $64.1 million in the fourth quarter of the previous year.

General and administrative expenses, or G&A, were 20% higher at $38.4 million in 2021, compared to $32 million in the previous year. The increase was primarily due to the inclusion of Spiritleaf results after acquisition in the third quarter.

G&A for Q4 2021 was $11.6 million, compared to $6.5 million in the fourth quarter of 2020, again reflecting the addition of the Spiritleaf retail operations.

In 2021, sales and marketing expenses, including Spiritleaf after the date of acquisition, decreased by 12% compared to the previous year, from $5.7 million to $5 million.

Sundial continues to focus on cost discipline, specifically when it comes to brand development and promotional expenses, targeting sales and marketing investments on priority strains and formats in select markets.

For the fourth quarter of 2021, sales and marketing expenses were $1.5 million, compared to $2.3 million in the previous fourth quarter.

During the year ended December 31, 2021, the Company raised $1.2 billion through a combination of registered direct offerings, warrant exercises, and at the market offerings. This has transformed Sundial's balance sheet to a position of strength and a source of opportunity.

As at December 31, 2021, the Company had an unrestricted cash balance of $558 million, and at April 25, 2022, unrestricted cash was $378 million. Total common shares outstanding were 2.4 billion on April 25, 2022.

In addition, our investment portfolio of secured debt and hybrid securities totals $597 million at April 25, 2022.

Now let's turn to cannabis cultivation and production.

Gross margin for the year ended December 31, 2021, was negative $15.5 million, compared to negative $49.9 million for the year ended December 31, 2020. The improvement of $34.4 million was due to a lower inventory impairment provision compared to the prior period, due to our commitment to delivering profitable product offerings to the consumer, as well as Sundial's ongoing focus on cost optimization, reduction of harvested inventory subject to potential impairment, and offering the most competitive and profitable strains and brands to its customers, against the backdrop of industry-wide price compression and high relative operating costs at our Olds facility. This demonstrates substantial progress on our path to sustainable positive gross margins, which are critical to our success.

Net revenue from cultivation and production operations for 2021 was $40 million, compared to $60.9 million in the previous year, reflecting industry oversupply, price compression, and our comprehensive portfolio review and SKU rationalization. In Q4 2021, net revenue from cultivation and production operations was $12.8 million, compared to $13.9 million in the prior year. Wholesale sales to licensed producers were reduced in 2021 to $9.8 million from $18 million in 2020 as we concentrated on retail sales.

As for the results of our retail operations, gross retail revenue from July 20, 2021, the date of acquisition of Spiritleaf, to December 31, 2021, was $16.1 million. Cannabis retail revenue comprised $10.2 million of retail cannabis sales to consumers at corporate-owned Spiritleaf retail cannabis stores and $4.3 million of revenue from Spiritleaf franchisees, representing royalty revenue, advertising revenue, franchise fees, and other revenues such as accessories, which totalled $1.6 million.

Gross revenue for the fourth quarter of 2021 was $10 million.

System-wide sales for the Spiritleaf network were $74.9 million from July 20 to December 31, 2021, and $41.4 million for the fourth quarter of 2021. System-wide retail sales represent the aggregate revenue earned by franchised Spiritleaf retail cannabis stores and corporate-owned Spiritleaf retail cannabis stores, and do not represent revenues that accrue to the Company. The Company receives all revenues from corporate-owned Spiritleaf retail cannabis stores, and royalties and advertising fees accrue from the franchised retail cannabis stores. The franchise revenue bears little overhead burden.

Gross margin for retail operations from July 20 through December 20, 2021, was $8.5 million.

Now let's turn our focus to our investment segment.

Sundial's investment income is reported as income from operations. Sundial intends to continue investing a significant allocation of our available capital in a targeted portfolio of attractive risk/return opportunities in the cannabis industry in debt, equity, and hybrid investments.

Summarizing the deployment of capital in our investment segment to date. In 2021, the Company deployed capital into more than a dozen cannabis-related investments totalling $578 million, including $396 million to the SunStream Bancorp, Inc., joint venture. In the fourth quarter of 2021, $89 million was directed to these investments, including $72 million to SunStream.

Our investment portfolio generated a net $1.6 million in investment income for the full year of 2021, including interest, fees, and gains and losses on marketable securities.

Unrealized losses of $65 million during 2021 were primarily due to publicly disclosed strategic investments in Village Farms International, Inc., and The Valens Company, Inc.

The Company's portfolio of secured credit-related investments through direct strategic investments and through the SunStream joint venture currently generates a weighted average annualized rate of return from interest of 12.3%.

Recent developments in volatility throughout the North American cannabis industry, including share price decline, challenging access to capital, distressed companies, and merger and acquisition activity, have created significant opportunities for Sundial's direct cannabis-related investments and the SunStream Bancorp credit portfolio.

Revenue from investments in the fourth quarter of 2021 was negative $19 million, including unrealized losses on marketable securities of $44 million due to share price fluctuations from our equity cannabis-related investments.

Now, I would like to invite Andrew Stordeur, President and COO of Sundial, to provide remarks related to cannabis operations.

Andrew Stordeur:
Thank you, Jim.

Twenty Twenty-one marked our third year of operation at our facility in Olds, Alberta, and was a transformational year for Sundial with our cannabis operations function. While we continue to enhance and develop our supply chain processes, I'm pleased with our team's consistent execution and commitment to operations excellence through our three pillars: people, process, and plants.

Now, let me walk you through some of the key highlights from the fourth quarter and Full Year 2021.

In terms of people, in 2021, we reconfigured our supply and operations teams to adapt to the industry dynamics. We invested in operations in end-to-end supply chain leadership capability at our old facility. This improved our demand planning and forecast accuracy, while also driving the proper discipline around cost optimization. On an equivalent year-over-year basis, our cultivation and production costs reduced by 27%, compared to an 18% reduction in grams harvested.

Our second pillar is around process. We implemented several improvements inside our indoor grow rooms, primarily focused on room environment, plant maintenance, and fertigation. We also invested in processing automation, increasing throughput and quality metrics on pre-roll production. Our OEE, or overall equipment effectiveness, saw improvements primarily on our pre-roll production line as we increased throughput by 67% in 2021 versus the previous year. Our packaging efficiency also improved by 60% from April 2021, when comparing the average minutes required to pack an individual 1.5 gram pre-roll format.

Our OTIFNE, or on time in full with no errors, which measures how well we are serving our customers, also showed material progress. Q4 2021 OTIFNE is 91.5%, up from 78.9% in the same period of the prior year; 2021 total OTIFNE is 93.2%, up from 73.2% in 2020.

Our average weight of potency achieved on flower lots fully tested in Olds set a record in the fourth quarter of 2021 at 22.4% THC potency. Our average weighted potency results continue to increase, with January and February 2022 results coming in at 23.3% THC and 24.3% THC, respectively, representing an increase of 3.6% compared to January 2021 and 4.9% compared to February 2021.

Further, in January 2022, our yield was up 58% versus January 2021 at 61 grams per square foot, and was up 21% at February 2022 versus February 2021, also at 61 grams per square foot. These improvements are starting to show in our product mix and margin improvement, as our reliance on the discount segment contributed 14% of our brand mix in the fourth quarter 2021, versus 24% in third quarter 2021, and greater than 30% in first and second quarters of 2021.

Moving forward into 2022, our cannabis products mix will continue to compete in the core and premium segments while we look to be opportunistic with competing in the high-volume segments of value and discount. Ensuring optionality as a seller and a buyer within the wholesale market is a focus area for a cannabis operations business and will be a key driver for improving product margin.

Our third pillar is around plants. Over the past year, the team has made tremendous progress in diversifying and improving our genetic library and continuing to build out our R&D capability. We have made progress with our premium product aspirations by becoming the number three premium flower brand in Québec, as well as the number two premium pre-roll brand in that market, with 20% share of the segment of flower and 40% share in the premium pre-roll segment, as measured by QC industry data.

In 2021, we were the first to launch infused pre-rolls with our Caviar Cones under our award-winning Top Leaf brand. Since its launch, Top Leaf has released three different Caviar Cones offerings. Caviar Cones were the number one concentrate SKU at launch in Alberta and British Columbia. After year end, Caviar Cones remain the highest-selling concentrate SKU as measured by SPPD, sales per point of distribution, within the province of Ontario.

In Q4, our commercial team was able to increase our priority SKU distribution growth nationally, versus Q3, by over 1082 points of distribution, as per internal CRM reporting. In Q4, priority SKUs represented 77% of Sundial's recreational revenue, versus 54% in Q3.

Moving forward, in 2022, our cannabis operations priorities will build off the progress made in 2021 and focus on five key initiatives.

Our first initiative is cultivation excellence. This will be achieved through continuous operational improvements in our indoor premium growing facility in Olds. We have improved all aspects of our cultivation consistency in 2021, and will look to build on this momentum in 2022.

Secondly, we are focused on cost optimization. Leveraging automation through all aspects of our end-to-end supply chain will allow us to remain competitive while also driving higher quality metrics as we push for sustainable profitability in our cannabis operations. We anticipate the need to increase our facility utilization as we realize synergies through key partnerships and growth opportunities that will spread our fixed costs over a more extensive cultivation and processing base.

Our third initiative is an enhanced portfolio. While we remain focused on the inhalable segments, we will right-size our vape strategy with a more focused portfolio under our Palmetto brand. We will also look for further opportunities to premiumize the category with high-potency high-terpene offerings such as live resin under our Top Leaf brand. After year end, we have launched several new cultivars nationally under our Palmetto, Sundial, and Top Leaf portfolio brands, including flower, pre-roll, milled flower, and concentrates.

Vertical integration is our fourth initiative. Increasing our branded portfolio through our store network will allow us to better control the end-to-end supply chain and take advantage of the profit pools as both a licensed producer and a retailer. Spiritleaf Selects is a great example of this initiative. Spiritleaf Selects is a private label brand of cannabis products now available in Spiritleaf stores. Private label offerings will allow Sundial to remain agile in responding to market demand around specific SKU and cultivar popularity to drive penetration further.

We will be enhancing our omni-channel experience across our entire portfolio. Whether direct to store, in store, or e-commerce, we will provide a consistent experience approach.

Finally, our fifth initiative is analytics and insights. With over 180 retail locations and thousands of daily shopper transactions, we have a unique ability as one of the largest vertically-integrated players in Canadian cannabis. This data will support a better shopping experience for consumers, with optimal assortment, price and promotion, while also supporting our customers nationally, through actionable insights that will allow them to make more money in retail. We are developing a comprehensive and world-class training program for our bud tenders nationally to give them the tools and capabilities to be successful. This strategy should support our goal of increasing our market share in our corporate stores and our franchise partner stores.

In summary, we have the resources to sustain and win in the Canadian cannabis market over the long term. We continue to drive further costs out of the business while also investing in capability and operational improvements as a critical enabler to unlocking value for our consumers and customers.

I will now turn the call back to Zach for closing remarks.

Zach George:
Sundial remains focused on building long-term shareholder value through the constant improvement in our cultivation practices and outcomes, increasing the efficiency of all aspects of our supply chain, accretive deployment of our cash resources, the expansion of our retail distribution network, and further streamlining of our operating structure, and enhanced offering of high-quality brands.

Thanks again for joining us today.

Operator:
We will now begin the analyst question-and-answer session. To join the question queue, you may press star then one on your telephone keypad. You'll hear a tone acknowledging your request. If you are using a speaker phone, please pick up your handset before pressing any

keys. To withdraw your question, please press star then two. We will pause for a moment as callers join the queue.

Our first question comes from Frederico Gomes of ATB Capital Markets. Please go ahead.

Frederico Gomes:
Hi, good morning, congrats on the quarter, thanks for taking my questions.

First question is just on your retail segment and the footprint there. You have 104 Spiritleaf stores today, so seems like the pace of new stores has slowed down. So could you comment on why is that, and what are your expectations for the number of stores by the end of the year, and what would be the mix in terms of corporate and franchises? Thank you.

Zach George:
Good morning. and thanks for the question.

As you know, we are dealing with a very volatile and dynamic environment in every segment of the industry in Canada. So we're not going to give guidance at this point, but you are right to point out that we are not focused on an aggressive rollout of doors into a market that is already obviously very saturated.

When you look at the performance of our other public peers, you can see that that saturation, along with oversupply of flower and other products, is really starting to bite in terms of profitability. So we're taking a cautious approach. We're expecting more consolidation, but we're also expecting this trickle of closures that we're starting to see to increase into the end of the year, which should take a lot of pressure off surviving retailers.

Frederico Gomes:
Great, thank you.

Then maybe just thinking about the broader macro environment that we're seeing right now in terms of inflation, so how are you thinking about that, and the impact that inflation could have in your credit portfolio, and the real rate of return that you're getting there? Thank you.

Zach George:
I think where you see it, you have to get beyond the macro, but we are seeing inflationary pressure at many levels of our business. The borrowers that are the source of that credit exposure are feeling the same. So I think what you're going to see is a credit quality impact, where in many cases because of the oversupply and market saturation we see in Canada, and the emerging pressure that you're seeing in individual mature states in the U.S., it's been very difficult to pass price through to the consumer. We think that that will come, but it's going to take more time. So in the meantime, we are doing everything possible to support our staff, make sure that we are competitive with wages, and there will be some investment required to get to the other side.

But while we're seeing the price of most consumer goods increase quite dramatically, we are not seeing that just yet across the board in cannabis. In fact, in Canada we're still seeing, in many pockets, sort of a race to the bottom on pricing. We expect that to change materially over the next 12 months.

Frederico Gomes:
Thanks, that's helpful.

Then maybe if I could, just one last question. On Alcanna, what's your outlook in terms of growth there? I know that's a more mature business, liquor retail, but do you expect to invest in that business to grow there, or it's just about milking those cash flows as you go forward? Thank you.

Zach George:
We couldn't be more excited about the colleagues that we've brought into this transaction and their deep experience in retail. So you have a retail infrastructure and team that has over two decades of experience in the retail landscape, in the regulated products landscape. So we are still heads-down working through integration. But what I would say is it's really two things. When you look at the last two years through the pandemic, you had off-premise consumption really skyrocket, as bars and restaurants were less accessible in Canada, and so that drove massive sales increases. So we expect those to moderate. But at the same time, there's a number of initiatives that we're looking at right now that we think can stabilize and meaningfully improve

profitability at that core business on the liquor side. We're working on those initiatives now and expect to be sharing those in the coming quarters.

Frederico Gomes:
Thank you. I'll hop back into queue.

Operator:
Once again, if you have a question, please press star then one.

This concludes the question-and-answer session. I would like to turn the conference back over to Zach for any closing remarks.

Zach George:
Thanks for everyone's time today. We look forward to updating you in the near future on our progress. Thank you.

Operator:
This concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.