Intro-act

Friday, July 17, 2020

VALUATION (Based on OTC: FLOOF)	
Current Price	**$0.35 (USD)**
52 Week Range	$0.25– 2.19
Market Cap ($-Mn)	85
Ent. Value ($-Mn)	162
Shares Out. (Mn)	243
Short Int (% Flt)	--
Daily Vol	147K
P/Book	0.9x
EV/ Sales	10x
EV/EBITDA	NM
P/E (CY19)	15x

FUNDAMENTALS	
Sales (CY19)	USD $10 Mn
Sales (CY20)	USD $33 Mn
Sales (CY21)	USD $91 Mn
Insider Owner	43%
Employees	87
EPS (CY20)	($0.03)
ROIC	-
Net Debt	USD $77 Mn

RELATIVE PERFORMANCE

CONTACT

Peter Wright
Intro-Blue
617-454-1088
peter@intro-blue.com

Please refer to disclaimers at the end of this report for more information about Intro-Blue, and this report.

Flower One Holdings Inc. (CSE:FONE/OTC:FLOOF)

Best-In-Class Execution & Market Share Gains Continue

Brand Launches & Focused Strategy to Accelerate Growth in 2H20

- **Key takeaways**: 1H20 firmly establishes FONE as the best-in-class name when it comes to large scale cannabis cultivation and extraction, brand portfolio development, product manufacturing, and retail fulfillment. Coupled with the company's focused growth strategy and cost optimization measures, FONE is well positioned for accelerated revenue growth and market share gains in 2H20.
    - FONE is now caught up on reporting, is past the COVID disruption, and is set to ramp in **2H20 with new brand launches expected to act as key catalysts**.
    - Business mix shift to premium brands in 2H20 will drive upside to sales volume (pre-sold for upcoming brand launches) and margins.
    - FONE has sufficient cash to get meet its expenses in 2H20. This, coupled with reduction in debt, lends balance sheet comfort – a standout performance given the current cannabis industry environment.
    - White label production and extraction business present huge growth opportunity and will be key to value creation (cash, margins, and multiple expansion).
- **FONE has managed the COVID disruption very well and is set to emerge stronger-than-ever in 2H20.** 1Q20 sales totaled $8.8 million, up 52% q/q, with $3.9 million in March alone, a monthly record for the company. While 2Q is likely to be soft ($3.8 million, above the original guidance), we believe FONE is set up for a very strong 2H20, with new brand launches acting as the key catalysts, supported by FONE's strong retail presence and scale. This is already evidenced in June sales, that grew 144% over May and 78% over April and continue to drive revenue growth and market share. We believe growth in 2H20 will be driven by the following **three strategic focus areas**:
    - **Value Drive #1: Connectivity with Nevada cannabis retailers.** FONE is one of the few, if not the only, cannabis company that interfaces with all 70 retailers in NV. That interface provides it with current up to minute market intelligence, which its operational team uses to improve the value proposition to retail accounts. For example, FONE's focus on the flower and pre-roll segments is guided by the 60%+ market share and 27% y/y increase of these segments in Nevada, and allows the company to act as a single source of supply for the widest range of brands and price points in the flower and pre-roll category. Its offering ranges from the value-based Old Pal to premium ones like Cookies and 22Red. In addition, FONE's scale, production capabilities, and diversity of SKUs, make it a reliable white label partner that can strategically manage shelf space.
    - **Value Drive #2: FONE's best-in-class brand partnerships – a key but hugely undepreciated value driver in our view.** We maintain that strong brands and shelf space (market share) are key to value creation in the cannabis industry and FONE scores very well on this KPI. In June, FONE signed Lift Tickets Laboratories, premium California brand and pre-roll innovator, as its 16th brand partner. Lift Tickets is expected to launch in 3Q20. In July, FONE successfully launched premium brands Cookies and 22Red into the Nevada market, and the launch inventory for both brands have essentially been pre-sold. In addition, FONE continues to achieve sales growth from recently launched vaping products, such as Old Pal, and will broaden its vape product SKUs with the launch of Heavy Hitters in 4Q20. By continuing to deliver in challenging times, FONE has reaffirmed its status as a seed-to-shelf partner of choice for brands looking to grow their business in Nevada. **We continue to believe that the Street is undervaluing FONE's brand portfolio, which includes best-in-class names and is a key valuation multiple driver in our view.**

- **Value Drive #3: FONE's strengthening value proposition to retail.** Cannabis retailers in Nevada are looking for two specific things: 1) to increase their margins, and 2) to strengthen their shelf space. FONE is the ideal partner for achieving both goals, thanks to its low-cost cultivation (harvest cash cost = $0.49/gm – among the lowest in North America), as well as the breadth of its SKUs (100+). FONE's low-cost, high-quality cultivation and full production manufacturing capabilities mean it can **produce everything from packaged flower to boutique concentrates.** This, coupled with its market leading scale, fulfillment proficiencies, and unparalleled reach in the Nevada market make it an all-in-one solution for the 70 Nevada cannabis retail customers.

- **Margins will be boosted by operational efficiencies and right-sized crop management plan put in place by the company, as well as growing white label production and extraction business**. In response to this temporary constriction of the Nevada cannabis market, FONE recalibrated its cultivation strategy and revise crop management plan to reflect the challenges brought on by the pandemic, while ensuring full protection and preservation of the quality of its existing live plant inventory. These steps have paid off, as evidenced by the recent successful launches of top shelf cannabis brands, Cookies and 22Red. Reduced production in 1Q20 (vs 4Q19) was a result of shift to quality over quantity to better serve newly launched and upcoming brand partners and resulted in a lower gross margin (28% vs 44% in 4Q19) and a $0.09 increase in cash cost/gm. However, higher contribution from sales of premium brands (Cookies and 22Red), lifting of restrictions in Nevada, expected growth in extraction business, and cost containment measures put in place by the company mean that margins will rebound in 2H20, with gross margin moving back to the 45%-to-50% range.

- **Capital position is strong, balance sheet is strengthening, and dilution is ready to subside.** FONE closed two non-brokered private placements on May 4, 2020, and June 29, 2020, totaling $13.9 million, and has sufficient cash to meet its CY20 expenses, a standout feature in the cash-starved cannabis industry. On June 8, FONE announced that that more than 56% of the November 15, 2019 debentures valued at ~$15 million have now converted. This, along with the conversion of 26% of the March 28, 2019 debentures valued at $43.1 million, has **eliminated ~$20 million in debt** from FONE's balance sheet. This signifies the confidence of the management in its growth strategy and given our expectations for positive cash flow in the coming quarters, we expect dilution to subside going forward, a positive for shareholders.

- **Stock is at an inflection point as FONE is on track to generate free cash in 2H20 and sentiment around cannabis stocks continues to strengthen**. FONE's strategy is aimed at ensuring that operations in each state generate free cash, which can then be deployed for expansion in the same or other states. We expect FONE's Nevada operations to generate free cash in 2H20, with 2-3x the profitability of the rest of the players. FONE spent ~$120 million to build its Nevada operations and current capex requirement is very low (maintenance), implying that FONE is on track to generate free cash. The improvement in fundamentals, coupled with the pickup in volume in cannabis stocks (per cannabis ETFs), suggests that FONE's undervaluation is likely to end soon as investors take cognizance of the company's investment potential and bid up the price to plug the price-value gap. **Stock is trading very cheap (CMP=$0.35) vs. our intrinsic value estimate of $3.20 per share, suggesting huge upside for investors looking to own a best-in-class cannabis cultivation and brand fulfilment play at modest valuations**.

Summary – FONE Business and Financial Updates

- **Revenue momentum from 2019 carried forward into 1Q20**. Revenue for the first quarter total 8.8 million, up 52% sequentially. March alone saw Flower One achieve 3.9 million in monthly sales, a record for the company.
    - **COVID-19 impact**. Although cannabis was deemed an essential service from March 20 to May 9, cannabis retailers in Nevada were temporarily required to close their physical storefronts to in-store sales. The closure of all businesses along the Las Vegas Strip until June 4 also had a notable impact on cannabis businesses across the state. FONE's 2Q20 sales are expected to moderate to $3.8 million.
    - **2H20 Catalysts**: Launch of two new brands – Cookies and 22Red – will be the major revenue catalysts for FONE in 2H20. The opening of Las Vegas casinos has already had a positive impact on revenues. June sale grew 144% over May and 78% over April, setting the stage for a strong 2H20.
- **Best-in-class manufacturing execution continues.** FONE's Neeham facility continues to operate at full cultivation capacity, with a focus on delivering premium grade flower along with refining strains specific cultivation formulas for 150+ cultivars contained in it genetic bank, as well as the proprietary genetics provided by its brand partners, such as Cookies. The breadth of skews emerging from FONE's production facility continue to increase, reflecting the company's continued focus on providing the widest and deepest range of high margin derivatives available.
    - **In 2Q20, FONE added additional Fresh Frozen capacity, expanding its capabilities to produce best-in-class concentrates and derivatives**, such as live resin sauce, and other premium products that several of its brand partners require to launch. FONE continues to optimize its fresh frozen harvest process and produces one of the best concentrates in the market.
    - **The breadth of SKUs (100+) emerging from FONE's production facility continues to increase**. It 55,000 square foot production facility, the largest in Nevada, has also made improvements and gained efficiencies in upstream extraction. Through continued improvements in efficiencies in the Company's upstream extraction processes, Flower One's first-pass distillate are now achieving an average of 92% THC across all lots. These enhancements ensure very stringent quality standards and have resulted in improved yields and reduced operating costs.
- **Brand partnerships continue to grow.** In March, FONE signed Heavy Hitters as its 15th brand partner with an expected launch in 4Q20, making them FONE's third vape brand launch this year. In June, FONE signed Lift Tickets Laboratories, premium California brand and pre-roll innovator, as its 16th brand partner. Lift Tickets is expected to launch in 3Q20. In July, FONE successfully launched premium brands Cookies and 22Red into the Nevada market, and the launch inventory for both brands have essentially been pre-sold. In addition, the company added 11 new bulk and retail accounts in 2Q20 to continue to broaden its overall customer base and maintain its retail penetration of over 90%.
- **In response to the COVID-19 disruption, FONE recalibrated its cultivation strategy and revised it crop management plan to reflect the challenges brought on by the**

pandemic. In developing the revised crop management plan, one of the top priorities was to fully protect and preserve the quality of live plant inventory. These efforts resulted in a robust dry flower inventory, representing some of the highest quality flower FONE has cultivated to date, as evidenced by the recent successful launches of top shelf cannabis brands, Cookies and 22Red. Given the quality of these harvests, FONE was able to effectively pre-sell both brands initial launch inventories.

- **FONE also completed a thorough sanitization of all its growing zones**, conducted preventative maintenance and checks on all of cultivation systems, and made significant progress for improvements in its greenhouse to enhance crop management and post-harvest methodologies. Management believes these efforts to fine tune the cultivation infrastructure and operational systems will pay dividends in 2H20 through the continued and consistent output of high-quality high-grade flower.

- **Cash cost increased to $0.49/gm in 1Q20.** This is $0.09 higher than the fourth quarter of 2019, but in-line with the third quarter of 2019. The variation in cost per gram is directly correlated with the variation in production of flower and extras.
- **Margins impacted due to reduced production and unfavorable business mix but expected to rebound in 2H20**. Cost of sales in 1Q20 was $6.3 million, inclusive of production cost expense and cost of inventory sold. This resulted in a gross margin of 28% for 1Q20, down from 44% in 4Q19. FONE reduced production for flower and extract from 4Q levels due to shift in focus from quantity to quality of flower to better serve newly launched and upcoming brand partners. FONE harvested 7.5 million grams of flower in 1Q20 vs. 12.1 million grams in 4Q19. On the extraction side, it produced 135,000 grams in 1Q20 vs. 486,000 grams of distillate in 4Q19. The recent premium brand launches will contribute to further margin growth over time. The company also expects that it will reduce its variable operating costs in 3Q20 as a result of completed operational efficiencies and right-sized crop management plan.
- **Inventory write-down impacted net profit**. Net loss for the quarter was $6.4 million, driven mainly by a one-time non-cash write-down of inventory totaling $10.6 million. FONE's sales declined in 2Q as a result of the COVID-19 pandemic. As a result, certain flower grown by the company was set to expire beginning in late 2Q through the end of 4Q. As such, management determined that a portion of inventory carried on the books will be sold as distillate or related products, instead of flower. This strategic decision to take a one-time non-cash write-down in Q1 2020 allows Flower One to extend the shelf life of this inventory and positions the company strongly for the opportunities presented by its newest brand partners and strains.

Chart 1: DCF Valuation – FONE

DCF Valuation

Assumption	
Riskfree Rate	1.45%
Market Risk Pemium	5.90%
Beta	
Costs of Equity	**7.35%**
Pretax Costs of Debt	11.66%
Effective Tax Rate	26.50%
After Tax Costs of Debt	**8.57%**
MV of Debt Est.	$32
MV of Equity Est.	$48
Debt-to-capital	**39.88%**
WACC	**7.84%**
Long-Term Terminal Growth Rate	2.25%
CMP	$0.35

	2019A 31-Dec	2020E 31-Dec	2021E 31-Dec	2022E 31-Dec	2023E 31-Dec
Operating Income	11.5	(27.8)	(3.2)	9.2	15.1
Tax Rate	*(172.3%)*	*0.0%*	*(26.2%)*	*(90.2%)*	*(263.1%)*
Cash Tax	19.8	0.0	(0.8)	8.3	39.7
NOPAT	**31.3**	**(27.8)**	**(4.0)**	**17.5**	**54.8**
Depreciation	1.4	9.1	10.3	10.3	10.3
SBC	2.7	1.6	1.6	1.6	1.6
Capex	(51.2)	(4.8)	(4.8)	(4.8)	(4.8)
Changes in WC	(17.4)	7.6	(37.3)	(34.2)	(28.2)
Free Cash Flow	**(35.9)**	**(16.0)**	**(35.9)**	**(11.3)**	**32.0**
Terminal Value (TV)					586.5
Free Cash Flow+TV	**(35.9)**	**(16.0)**	**(35.9)**	**(11.3)**	**618.6**
Enterprise Value	340.2	402.8	450.3	521.5	573.6
Net Debt	(0.1)	42.4	74.0	87.7	111.6
Equity Value	**340.1**	**445.2**	**524.3**	**609.2**	**685.2**
No. of shares	184.1	214.3	214.3	214.3	214.3
Equity Value per Share	**$1.85**	**$2.08**	**$2.45**	**$2.84**	**$3.20**

Source: Intro-act, Company, FactSet

Chart 2: Financial Model – FONE

Flower One Holdings Inc. (CSE:FONE) Figures in USD Million	2017A 31-Dec	2018A 31-Dec	2019A 31-Dec	2020E 31-Dec	2021E 31-Dec	2022E 31-Dec	2023E 31-Dec
IFRS Income Statements:							
Revenue	NA	0.1	9.5	33.4	91.0	128.5	152.1
Y/Y			*NM*	*252.6%*	*172.3%*	*41.2%*	*18.4%*
Q/Q							
Cost of Sales		0.1	6.4	16.7	43.2	61.0	72.2
% of Revenue		*101.6%*	*68.0%*	*50.1%*	*47.5%*	*47.5%*	*47.5%*
Gross Profit before Fair Value Adjustments		**(0.0)**	**3.0**	**16.7**	**47.8**	**67.5**	**79.9**
Realized Fair Value Adjustment on Sale of Inventory		(0.0)	(2.1)	(4.1)	0.0	0.0	0.0
Unrealized Fair Value Adjustment on Growth of Biological Assets		0.5	31.3	7.5	0.0	0.0	0.0
Provision for inventory							
Gross Profit		**0.4**	**30.7**	**9.5**	**47.8**	**67.5**	**79.9**
% of Revenue		*334.1%*	*323.5%*	*28.4%*	*52.5%*	*52.5%*	*52.5%*
Operating Expenses:							
General and Administrative		5.1	18.6	29.4	40.7	48.0	54.5
Share-based Compensation		3.2	2.7	1.6	1.6	1.6	1.6
Depreciation		0.1	0.5	7.9	10.3	10.3	10.3
Total Operating Expenses		**8.4**	**21.9**	**38.9**	**52.6**	**59.9**	**66.3**
Income (Loss) from Operations		**(7.9)**	**8.8**	**(29.4)**	**(4.8)**	**7.6**	**13.5**
% of Revenue		*NM*	*92.9%*	*(88.1%)*	*(5.3%)*	*5.9%*	*8.9%*
Non-Operating Income (Expense):							
Accretion Expense		NA	(5.1)	(2.0)	0.0	0.0	0.0
Interest Expense			(8.9)	(16.7)	(18.3)	(19.2)	(19.2)
Transaction Costs			(2.0)	0.0	0.0	0.0	0.0
Finance Expenses			(16.0)	(18.7)	(18.3)	(19.2)	(19.2)
Listing Expense		(3.8)	0.0	0.0	0.0	0.0	0.0
Fair Value Gain (Loss) on Derivatives		NA	12.5	30.0	30.0	30.0	30.0
Gain (Loss) on Note Payable Modification			1.0	0.0	0.0	0.0	0.0
Foreign Exchange Gain (Loss)		(0.6)	(1.4)	12.2	12.2	12.2	12.2
Total Non-Operating Income (Expense)		(4.4)	(4.0)	23.6	24.0	23.1	23.1
Net Income (Loss) before Income Taxes		**(12.4)**	**4.8**	**(5.8)**	**19.2**	**30.7**	**36.6**
Income Tax Expense (Benefit)		0.1	4.3	(0.8)	5.6	9.0	10.7
Tax Rate		*(0.6%)*	*89.1%*	*13.0%*	*29.3%*	*29.3%*	*29.3%*
Net Income (Loss) and Comprehensive Income (Loss) for the Period		**(12.4)**	**0.5**	**(5.1)**	**13.6**	**21.7**	**25.9**
% of Revenue		*NM*	*5.5%*	*(15.2%)*	*15.0%*	*16.9%*	*17.0%*
Earnings Per Common Share:							
Basic		($0.09)	$0.00	($0.02)	$0.07	$0.12	$0.14
Diluted		($0.09)	$0.00	($0.03)	$0.06	$0.10	$0.12
Y/Y		*NA*	*NM*	*NM*	*(287.6%)*	*59.7%*	*19.2%*
Q/Q							
Weighted Average Shares Outstanding:							
Basic		138.2	180.1	188.0	188.0	188.0	188.0
Diluted	138.2	138.2	184.1	214.3	214.3	214.3	214.3

Source: Intro-act, Company, FactSet

General Disclaimer and Copyright

This report has been issued by Intro-act, LLC, in consideration of a fee payable. Fees are paid upfront in cash without recourse. Intro-act, LLC may seek additional fees for the assistance with investor targeting, access, and further investor preparation services, but does not get remunerated for any investment banking services. We never take payment in stock, options, or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources who are believed to be reliable. However, we do not guarantee the accuracy or completeness of this report, and have not sought for this information to be independently verified. Opinions contained in this report represent those of the Intro-act analysts at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, and estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties, and other factors that may cause the actual results, performance, or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Intro-act, LLC shall not be liable for any direct, indirect, or consequential losses, loss of profits, damages, or costs or expenses incurred or suffered by you arising out or in connection with the access to, use of, or reliance on any information contained in this note.

No personalized advice: The information that we provide should not be construed in any manner whatsoever as personalized advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Intro-act's solicitation to affect, or attempt to affect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Intro-act has a restrictive policy relating to personal dealing and conflicts of interest. Intro-act, LLC does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees, and contractors of Intro-act may have a position in any or related securities mentioned in this report, subject to Intro-act's policies on personal dealing and conflicts of interest.

Intro-act is not registered as an investment adviser with the Securities and Exchange Commission. Intro-act relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a) (11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Intro-act does not offer or provide personal advice, and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell, or hold that or any security, or that any particular security, portfolio of securities, transaction, or investment strategy is suitable for any specific person.