Transcript

Cresco Labs Q2 2023 Earnings

Wednesday, 16 August 2023

Operator Good morning and welcome to Cresco Labs' second-quarter 2023 earnings conference call. On today's call we have chief executive officer and cofounder Charles Bachtell, chief financial officer Dennis Olis, and chief transformation officer Greg Butler, who will be available for the Q&A. Prior to this call, we issued our second-quarter earnings press release, which has been filed on SEDAR and is available on our investor relations website. These preliminary results for the second quarter of 2023 are provided prior to the completion of all internal and external reviews and therefore are subject to adjustment until the filing of the company's quarterly financial statements. We plan to file our corresponding statements and MD&A for the quarter ended June 30th, 2023 on SEDAR and EDGAR later today.

Certain statements made on today's call may contain forward-looking information within the meaning of applicable Canadian securities legislation as well as within the meaning of Safe Harbor provisions of the United States Private Securities Litigation Reform Act of 1995. These forward-looking statements may include estimates, projections, goals, forecasts, or assumptions that are based on current expectations and are not representative of historical facts or information. Such forward-looking statements represent this company's beliefs regarding future events, plans, or objectives which are inherently uncertain and are subject to a number of risks and uncertainties that may cause the company's actual results or performance to differ materially from such forward-looking statements, including economic conditions and changes in applicable regulations. Additional information regarding the material factors and assumptions forming the basis of our forward-looking statements and risk factors can be found in our earnings press release and in Cresco Labs' filings on SEDAR and with the Securities and Exchange Commission.

Cresco Labs does not undertake any duty to publicly announce the results of any revisions to any of its forward-looking statements or to update or supplement any information provided on today's call. Please note that all financial information on today's call is presented in US dollars. All interim financial information is unaudited. In addition, on today's conference call Cresco Labs will refer to certain non-GAAP financial measures such as adjusted EBITDA, adjusted gross profit, adjusted gross margin, and adjusted SG&A, which do not have any standardised meaning prescribed by GAAP. Please refer to our earnings press release for the calculation of these measures and a reconciliation to the most directly comparable measures calculated and presented in accordance with GAAP. These non-GAAP financial measures should not be considered superior to, as a substitute for, or as an alternative to and should only be considered in conjunction with the GAAP financial measures presented in our financial statements.

With that, I'll turn it over to Charlie.

Charles Bachtell Good morning, everyone, and thank you for joining us on the call today. As we introduced in Q1, we've dubbed 2023 the year of the core because we're laser-focused on the things that make Cresco the strongest company possible, our core markets, core stores, core brands, and core products. By rationalising and optimising everything we do, we're strengthening our business for today's environment while best positioning ourselves for the future, as reflected in our very solid Q2 results that we're going to discuss today.

In the quarter we generated $198 million of revenue, up 2% sequentially, by prioritising our core strengths. With our focus on driving scale and efficiencies across the entire organisation, we've been accomplishing more with less,

leading to an $11 million sequential improvement in adjusted EBITDA, a 38% sequential growth. We're pleased to share that this quarter showed growth in our top line, our gross margin, adjusted EBITDA, and operating cash flow. These results are just starting to reflect the decisions we made and conveyed earlier this year to support our year of the core priorities. We understood the assignment and we're executing against it with much more to come.

It's important for us to start with the decision to terminate the Columbia Care transaction, which aligns with our objectives for the year of the core. While we still believe in the fundamentals of the deal, we always knew that we must come out of any transaction as a stronger combined company than we would be as a standalone company. The changes in the industry and broader macro environment made it impossible to get the value we needed from divestitures to make the economics work. On the flipside, these same dynamics are what create plentiful opportunities for targeted and capital-efficient growth ahead. The disciplined prioritisation of our strong core is the best way to position ourselves to exploit these incredible opportunities in the coming quarters.

Now I'm going to share an update on how we're executing on the three pillars of our three-year strategic plan, ensuring we have the most strategic footprint, broadening our wholesale brand leadership, and driving retail productivity across a larger base. Number one, we're ensuring we have the most strategic geographic footprint. Our objectives for the year of the core are clear. With constantly shifting regulatory and competitive landscapes, we must be as dynamic as our industry and environment. We're continuously evaluating our markets to ensure a footprint that maximises stability, bottom-line growth, free cash flow, and competitive positioning.

To that end, we've taken a critical look at our operations in the few states that are below our margin targets, namely, California and Maryland. Last quarter we told you that we rationalised underutilised facilities in California and we're focusing on FloraCal, distributed through a third party, as our go-forward strategy in the state. Thanks to these actions, we eliminated most of our fixed costs in the state, improved productivity in the remaining facilities, and now run a much leaner platform for our brands to compete. We also sold our standalone processing facility in Maryland as it didn't provide us with a pathway to verticality in the state. While we'll forego a small amount of revenue, we were able to eliminate the fixed costs in that state, creating a net-positive bottom-line impact. Our focus on the core wasn't limited to these states.

We also further evolved our organisational structure in every market to align with our core priorities. Our structure continues to get leaner and more agile so that we can quickly pivot alongside market conditions and react even faster to feedback from consumers. As just one example, our commercial team in Illinois is now leaner than it was before adult use began in 2019 and yet the team is generating 10X the revenue and has maintained our number-one market share in the state. This is only possible because we're constantly evaluating and adapting our org design, processes, and technology to drive efficiencies. Every change we make to our footprint is designed to meet the moment while also planning for the future of our organisation and industry. Our core markets are driving improved profitability and cash flow. This positions us well to fund the growth opportunities existing within our footprint from anticipated adult use catalysts as well as the expansion opportunities that lay ahead.

Number two, we held our leadership position in brand and wholesale products. Long-term, we believe this industry will look a lot like beer, wine, alcohol, and other CPG categories that rely on brand-building to capture and retain loyal customers. Our specialty is developing brands that are beloved by consumers across markets, so we are focused on doubling down on our core brands and products. According to BDSA, we have the number-one portfolios of both branded flower and branded concentrates, the number-three portfolio of branded vapes, and number-four portfolio of branded edibles. In our core markets of Illinois, Pennsylvania, and Massachusetts we continue to hold the number-one overall share position.

We continue flexing our brand-building muscles to launch smart innovations that premiumise the portfolio and extend our core brands and products, all while reducing our unit costs. Specifically, we're looking at proven segments like prerolls where we already have the expertise and capabilities but we've historically underindexed. A good example of these strategies coming together is the launch of FloraCal infused prerolls and High Supply infused shake in Illinois. The market response to these new form factors has been phenomenal. Plus, we're taking what was traditionally the low-value byproduct of our high-end flower and turning it into new revenue streams.

As another example, last quarter we talked about launching Troches in Pennsylvania to address a core form gap in that market. The demand for this product has already exceeded our initial expectations and we're building on the momentum by introducing Sweet Troches in Pennsylvania this fall. We have a proven track record of building our brands to meet market conditions and we're leaning into that expertise to get even more out of our core brands and products. When we look at our streamlined footprint, our brands are still holding strong number-one share positions in three of our markets and we have targeted strategies in place to continue to grow our share across our footprint, especially as we look at the anticipated adult use conversions in Pennsylvania, Ohio, and Florida.

Number three, we're driving efficiencies from highly productive retail in the most strategic states. Our investment in retail continues to pay off. We saw last quarter's boost in productivity continue in our core markets and stores in Q2, even in the face of new competition. We're particularly proud of our continued success in Illinois, where we were able to outcompete and essentially hold our total market share even with 15 new competitive doors opening in the quarter. On average, across our core markets, we're indexing at 1.4 times our fair share. This strength points to our phenomenal customer experience, bolstered by our proprietary e-commerce platform and loyalty programme, which saw over 35% growth during the quarter. In fact, we find that when shoppers engage with these tools, they spend 26% more than the average shopper.

Our customers also appreciate that we're handling their transactions more efficiently than ever. During the quarter, we handled 11% more customers and units sold at Sunnyside year over year, all with a 20% leaner retail workforce. We're able to move faster by continuously finding incremental efficiencies in our employee training, customer throughput process, and proprietary inventory management software. Consumers love the retail experience at Sunnyside. What's more, between our revenue-generating technologies and our proprietary internal processes, we have a blueprint that's repeatable and transferrable. We will leverage this foundation as we continue to expand our retail footprint quickly and successfully where it aligns with our core priorities.

In closing, our second-quarter results reflect the early impact of the steps we've taken across the entire organisation to improve margins and materially strengthen the company. By rationalising and exiting margin-dilutive operations, investing wisely in innovation and brand-building, and continuously improving our robust retail infrastructure, we were able to significantly improve our profitability in the quarter with more to come in the second half. The current industry climate and capital availability will create exciting opportunities in the months ahead and we believe a stronger, leaner Cresco Labs sets us up for continued growth from our core and to take advantage of the many capital-efficient opportunities for expansion that we see on the horizon.

With that, I'll turn it over to Dennis to provide more details on our Q2 performance.

Dennis Olis Thank you, Charlie, and good morning, everyone. I'll be reviewing the financial results from the quarter, then highlighting a few items from the balance sheet and discussing our capital position. As Charlie said, we are pleased with our results in the second quarter. We are navigating industry-wide pressures and we've taken steps across our organisation to prioritise P&L strength and cash flow and those efforts are beginning to show in our results. In the quarter we generated $198 million in revenue, a 2% increase quarter over quarter from the same state footprint. The increase was driven by 4% sequential revenue growth in our retail operations, where we improved both our absolute share and fair share in most markets. Wholesale revenue was essentially flat from Q1, an impressive result as our brand performance offset the increased verticalisation by our MSL customers and the impact of Missouri's adult use on retailers along the Illinois-Missouri border. Improvements in efficiencies across the platform and our decision to exit margin-dilutive operations drove improved gross margin this quarter. Overall, adjusted gross margin in the quarter increased 100 basis points sequentially to 47%.

We expect continued improvement in gross margin in the second half as we sell through legacy, higher-priced inventory and realise the full benefit of the cost-savings initiatives taken in the first half of the year. Total adjusted SG&A declined by $7 million from Q1, a direct result of the actions taken in Q1 and Q2 to streamline our operations and reduce our overall expenses at corporate. This sequential decline is particularly impressive as it includes the cost of opening five dispensaries in the quarter. Again, these actions should continue to drive improving margin in the second half as we realise the full benefit of the changes. We generated $40 million of adjusted EBITDA, up 38% from $29 million in Q1. Adjusted EBITDA margin was up 540 basis points to 20% in the quarter. As I have already highlighted, we expect continued improvement in adjusted EBITDA margin throughout the second half of the year as we execute on the year of the core. We generated $18 million in operating cash flow in the quarter, which is inclusive of $14 million in one-time cash costs related to the shutdown of California operations, severance payments, and Columbia Care transaction-related fees.

We continue to focus on improving our working capital management. We reduced inventory by $12 million and continue to drive additional working capital initiatives to improve operating cash flow. These actions, along with the cost-saving initiatives we've already discussed, should drive higher operating cash flow in the second half when compared to the $21 million we generated in the first half, even after required tax payments. In the first half of the year we spent $38 million in capex, but expect this number to drop substantially in the second half with a full-year

plan of around $50 million. We ended the quarter with $75 million of cash on the balance sheet and we feel good about this cash position.

Looking ahead to the second half of 2023, we expect total revenue to be down high single-digits compared to the first half of the year. While we will see retail gains from new stores in Florida and Pennsylvania, they will be offset by our decision to rationalise and exit certain California, Arizona, and Maryland operations. That said, these same decisions will drive improvements in gross margin and adjusted EBITDA margins in the second half of the year. Improvements in working capital, substantially lower capex, and continued improvements in margins will also drive higher free cash flow in the second half of the year.

Before I turn it back to Charlie for closing comments, the base prospectus filed today is simply replacing the former prospectus that recently expired. The company has no plans to raise funds under the prospectus in the near term. With that, I'll pass it back to Charlie.

Charles Bachtell Before we close, I want to speak to the issue of federal reform, the largest unlock of shareholder value. I've spent a lot of time in DC this year, working to educate, build trust, and give legislators all the context they need to make thoughtful decisions. There are a lot of constructive conversations happening and the right leaders are actively engaged around SAFE and the rescheduling of cannabis. There are solid indicators that progress is being made, but real progress requires action and we need to see congressional action in the months ahead. As we wait for change at a federal level, we're working to improve every aspect of the business to best position ourselves in the interim. We're managing through the environment of today to improve profitability while at the same time optimising the company for the industry of tomorrow.

These changes are never easy, but I want to thank the amazing Cresco Labs team for stepping up to do more with less as we navigate through the dynamic nature of this emerging industry. The long-term cannabis growth story remains unchanged. Cannabis is still positioned to be one of the largest consumer products categories in the US and Cresco Labs is doing what needs to be done to secure long-lasting industry leadership and build shareholder value. We are leaning into our core by investing in our largest, highest-margin markets while deemphasising those markets that negatively impact margin, driving operating efficiencies throughout our entire organisation, investing in brand and retail innovation to provide the consumer with the best cannabis experience possible, and we're generating more free cash flow to strengthen our balance sheet.

With that, I'll open up the call for questions.

Operator Thank you. If you would like to ask a question, you may do so by pressing star followed by one on your telephone keypad. To revoke your question, please press star followed by two. When preparing for your question, please ensure your phone is unmuted locally. Our first question is from Aaron Grey from Alliance Global Partners. Aaron, your line is now open. Please go ahead.

Aaron Grey Hi. Good morning. Thank you for the question and nice to see the margin of improvement quarter over quarter there. First question from me. I just want to take a high-level view for Cresco. Wholesale has always been a standout for you. It seems like it stabilised quarter over quarter in terms of declines you had seen prior. So are you feeling like some of the impacts you guys had of verticalisation and others introducing value brands is now behind you, at least the pain that you guys had felt because you guys were the leading wholesaler ahead of that? Then, also, just looking at some of the markets, I know you've exited some such as California, where you're looking to go asset-light. But when you look at Michigan, where you're not vertical and you've pointed at some of the wholesale success, what do you think is something that has led you to success in Michigan, to getting those share gains at a good profit? Are there signs you might be able to find a way to replicate that to be strong at wholesale without having to be vertical? Thank you.

Charles Bachtell Good morning, Aaron. Thanks for the questions. First question as far as, has the impact of increased verticalisation been normalised… At this point we would still say no. I think you're going to continue to see vertical operators continue to prioritise more of their own shelf for their own brands. Again, in this current environment for the sector where price compression is still around, margins continue to get challenged. That's a very useful tool in helping to support margins. So I think we need to plan at least for continued pressure to be there, but, like you said, our overall thesis hasn't changed. The long-term thesis here in cannabis is that you want to create consumer brands and you want to get them onto all of those new, more-likely-than-not independent doors that open as these markets continue to expand.

On the second question, wholesale performance in Michigan, we're pleased. We're not vertical there. I will tell you, it is a more challenging go-to-market strategy when you don't have the tool, the benefit, the lever to pull on that is owned shelves. Your product has to speak for itself and I think that's a testament to the quality of the team there and the uniqueness of what they do to bring differentiated quality products to market and meeting the consumer where the consumer wants to be met. It's that perceived value quotient that we're executing well against in that state. Greg, you want to add anything?

Greg Butler No. Aaron, the only thing I'd say is just back to your question on wholesale performance. Just building one more point on Charlie's, we also have to look at the impact of cross-state purchases, out-of-state purchases, and how that'll impact our markets in some of our states. That is another drag on the wholesale performance in the second half.

Aaron Grey Great. Thanks for that colour. I appreciate it. Second question from me. I just want to turn more specifically to Florida, strong data from the weekly data that we get from the state. I know you're opening some stores as well, but even on a per store basis it looks strong. So could you speak to what you think is driving that performance and how you look at the promotional environment in the state as it remains very competitive from some of the larger players there? So how you're looking at the overall landscape in Florida and how you look to succeed there would be helpful. Thanks.

Greg Butler Hey, Aaron. Why don't I take that as well? So we're very pleased with what the team has been able to do in Florida. This quarter we opened three more stores and that really is our strategy for the state, which is getting our footprint up in the right markets where we can drive material value and then also, from our back end of our operations, really bringing best-in-class products to our stores. We've been pleased with some of the innovation that we brought into Florida, which has helped us win. From a price promotion perspective, you're absolutely correct. Prices still are tough. There's a lot of price promos happening every week in the state and our view on that is, the way that we can compete really is twofold. One is, bring superior products to our stores and then be able to drive down our costs and drive up efficiencies in our [unclear] to really help us compete on pricing when we have to. But we don't see a material slowdown on price promotions in the second half of the year.

Aaron Grey Great. Thanks very much for the colour. I'll jump back in the queue.

Charles Bachtell Thanks, Aaron.

Operator Thanks, Aaron. Our next question comes from Andrew Partheniou from Stifel. Your line is now open. Please go ahead.

Andrew Partheniou Thanks. Good morning and congrats on the great quarter here. I wanted to talk a little bit about taxes if we could, please. Could you give a little bit of colour on tax payments in Q2? How should we be thinking about taxes in the second half? You did call out better free cash flow in the second half. As well, maybe more at a high level, could you talk a little bit about minority distribution? Could you talk a little bit about that line item in the financing section of your cash flows and any initiatives you're looking at to improve on that going forward?

Charles Bachtell Good morning, Andrew. Thanks for the question. Dennis will handle that.

Dennis Olis Thanks, Andrew. So in Q2 we paid about $22 million in taxes. Part of that was federal. Part of it is state. As we go into the second half of the year, as we talked about on the last earnings call, with the extension of our 22 tax return that will be filed in October, we will make that payment of about $50 million in Q4 as it relates to 2022 taxes. Otherwise we're current in-year on all of our state taxes and we'll continue to do so throughout the course of the second half of the year. As it relates to the NCI distributions, the largest component of the NCI distributions is really a federal tax payment in-year that we make to our UP-C holders, which represents about 35% to 40% of the total tax liability. So, within the current year, we are paying our federal taxes through the NCI parties within the year. So you'll continue to see those payments made throughout the balance of the year. Again, that's just taking a portion of our federal taxes and paying that in-quarter throughout 2023 and we expect to continue to do that through the balance of the year.

Andrew Partheniou Thanks for that. Maybe thinking about capital allocation and source of funds, could you talk a little bit about how you see the landscape of decision-making, how you prioritise capital allocation, whether it's capex, reducing debt, M&A, or anything else? As well, with each one of these buckets, how are you thinking about

paying for that, whether it's cash shares, any further sale leasebacks or mortgages that you could pull levers on? Thanks.

Charles Bachtell Andrew, this is Charlie. I'll take that or I'll start that. So on future capital allocation, as we mentioned in the prepared remarks, the same thing that challenged the Columbia Care transaction is the same thing that creates opportunity for some pretty capital-efficient growth in quarters ahead. So we're observant. We're focusing on the core. We're making sure we're as strong and we're supporting these core markets that do drive the vast majority of our revenue and potential profitability, but in doing so, that is of course to make sure that we're as strong as possible to execute on growth initiatives going forward. As far as where capital sources can come from, we do have unencumbered properties if we need to. We're evaluating some mortgages. No intentions of doing any equity raises at this point. For the right M&A transaction that can solidly improve top line and at least be net-neutral to positive on the bottom line, we'll evaluate whether it's cash or the use of equity for those. But, again, we're going to be really disciplined in watching how this continues to unfold and see those opportunities continue to present themselves.

Andrew Partheniou Thanks and I'll go back in the queue.

Charles Bachtell Thanks, Andrew.

Operator Thanks, Andrew. Our next question is from Scott Fortune from Roth MKM. Scott, your line is now open. Please go ahead.

Scott Fortune Good morning and thanks for the question. I just want to focus a little bit on your cash flow generation and your expectations there through the cost initiatives but, more importantly, inventory. Just focus on the inventory. Where are you at with the focus on the core? What are the inventory levels that you expect to get to with turns or days or any additional inventory management to continue to improve cash flow? How should we look at that going into the second half here?

Charles Bachtell Thanks, Scott. We'll have Dennis take that.

Dennis Olis Thanks for the question, Scott. From an inventory standpoint… I'll start with that. We've historically run at about $150 million or so inventory balance at the end of the quarter for the bulk of 2022. We've made a concerted effort to work that balance down to a more reasonable level. We took it down to 130-something in Q1. We ended the quarter with just over $120 million in inventory at the end of the year. So we're proud of the fact that our inventory turns. We continue to manage that very closely and watch that. We would expect that to shrink a little bit as we go into Q3 based on some of the actions that we took at the very end of the quarter in California and in Maryland. So there will be a continued focus on managing our inventory levels. As for the cash flow forecast, we expect to be operational and free cash-positive for the second half of the year and for the full year. That's inclusive of the tax payment that we'll be making in October. So we are continuing to generate cash and some of the actions that we've taken in Q1 and Q2 are having a benefit not only on the P&L but on our cash flow as well.

Scott Fortune I'll follow up on that. Can you provide more additional colour on the cost side of things, the initiatives you've put in, in driving that cost savings into the cash flow? How do you see the cash flow improvement coming from… Just unpack that a little bit. Do you have much more room? Quantify those cost efficiencies moving forward here for you guys.

Dennis Olis Scott, really what drove the P&L savings and therefore the cash savings is really focusing on the core and really focusing the business on margin-accretive businesses and really looking at the margin-dilutive businesses and really trying to minimise or eliminate the impact of those margin-dilutive businesses. So a lot of the actions that we took both from a headcount standpoint and other non-headcount-related costs related to the core. Most of those were corporate expenses that we took at the end of Q2. So there will be some carry-forward that will get the benefit of a full quarter in Q3 and Q4 for some of those actions. So we do expect our cost structure to continue to reap the benefits of the actions that we took in the first half in the second half of the year.

Scott Fortune I appreciate the colour and I'll jump back in the queue.

Charles Bachtell Thanks, Scott.

Operator Thanks, Scott. Our next question comes from Luke Hannan from Canaccord Genuity. Luke, your line is now open. Please go ahead.

Luke Hannan Thanks. Good morning. My first question here is on loyalty. Specifically you called out, I believe it was in Illinois, the strength of spend and engagement that you're seeing from those customers that you have enrolled in your loyalty programme. I'm just curious to know, one, what is the overall penetration maybe in terms of the percentage of customers or essentially of transactions, what have you, of your loyalty programme? Then, also, how well developed this is across your operations and maybe what the future plans are for that.

Charles Bachtell Morning, Luke. Greg will take that.

Greg Butler Morning, Luke. How are you? So we're really pleased with what we're seeing in our loyalty programme. Just for some background, as you know, we built really a custom solution for Sunnyside. The primary reason for that is that it gives us an opportunity to do a little bit more than what some of the off-the-shelf solutions give us today. The business performance perspective as we look at loyalty… Loyalty recently rolled out over the last couple of months. It's starting to gain steam. I think Megan will get you specifically the penetration numbers, but as we look at what loyalty does for us, what we see is, one, our high-value customers engage in it, which is great, but the biggest opportunity for us in loyalty is that it does allow us to start to get the one-to-one, both connections and also promos, to customers.

If you've been following the space for a while, what we said is, price promotions in cannabis retail have been fairly unsophisticated. It's been things like total store off, 50% off all products. Where we are taking Sunnyside and what we've been really pleased with what the team has been able to do is start to generate some very smart, customised, one-to-one offers that help us either grow baskets with customers who are high-value flower shoppers. It allows us

to direct offers to really grow baskets through add-ons and trials and then also reward those customers that we believe to the best of our ability are driving the majority of their wallet at a Sunnyside location. Because of that and as Dennis has mentioned in the financials, our ability to drive smarter price discounts to really help margins in our stores has been quite impressive in the first half of this year and we think that's going to continue to improve in the second half.

Luke Hannan That's helpful. Then my follow-up here… There's already been a little bit of discussion on SG&A so far during the call and, Dennis, I appreciate your commentary on the improvement that you're able to recognise there in Q2 despite the… I believe it was five dispensary openings during the quarter. I'm trying to get a better sense of… So for the balance of the year, there is a step down in capex, which I am somewhat interpreting as also maybe a slight slowing of the store-opening cadence in the balance of the year. To me that suggests, maybe on an absolute dollars basis, we should see a more meaningful improvement in Q3 and perhaps Q4 than what we saw in Q2. Is that fair or is there anything that potentially I'm misunderstanding there?

Dennis Olis So there will be a step down in total absolute dollar spend in SG&A from Q2 to Q3. A lot of the actions that we took were felt in Q2, so the magnitude of the step down will not be as great from Q2 to Q3 as it was from Q1 to Q2. The Q2 numbers also included actions that we took in Q1 that we got the full benefit of in Q2. We did take a number of actions in Q2 that will have some remaining benefit as we go into the balance of the year. If you look at our total SG&A spend, Q4 to Q1 we were relatively flat. Since then we've added 13 additional stores. So I'm really proud of the fact that, despite the fact that we've added 13 stores in the first half of the year, we were able to reduce our SG&A expense pretty materially in Q2 and we expect that to see continued improvements as we go into the second half of the year. As for capex, the bulk of the investments that we've made for the new store openings, the 13 stores that we opened, as well as the completion of some of the work that we're doing in our New York facility will be completed at the end of the first half of the year. So our capex spend as we go into the second half of the year will be materially less and our forecast for the full year is about a $50 million capex spend.

Luke Hannan Very helpful. Thank you.

Charles Bachtell Thanks, Luke.

Operator Thanks, Luke. Our next question comes from Frederico Gomes from ATB Capital Markets. Your line is now open. Please go ahead.

Frederico Gomes Hi. Good morning. Thank you for taking my questions. I'm just curious. Given your leadership position in wholesale, I'm just curious, what kind of shift are you seeing in consumer trends with respect to product tier selection and how you might be looking at their good-better-best strategy and how you're thinking about adapting to that shift in consumer trends?

Charles Bachtell Thanks, Frederico. Greg, do you want to handle that one?

Greg Butler Morning, Frederico. Thanks for the question. From a wholesale perspective, from our vantagepoint, we have great insights not only from our wholesale sales but also from our retail sales. Thinking of the macro level, you're not seeing a lot of shifts between flower's share of the market, either whole flower or preroll, edibles, and others. The biggest trends we've seen for the first half of this year and likely the trends that are going to be in the second half of the year… One is really the shift to both value and then premium. Value brands, ours included, are some of the biggest growers in our portfolio, but others have launched value brands. I think that shoppers who are looking to find a better absolute price per unit are seeking value brands. But we're also seeing that when you have differentiated products like what we've done with FloraCal or Cresco Liquid Live Resin, you can command a premium price as well. So what I would generalise all this into is that consumers are appreciating the choice we're seeing.

I think what you also see in our data is, just because you're a value shopper on one occasion in one format doesn't mean that's all you're going to buy. It usually means that you're supplementing maybe a value flower purchase to help you afford a more premium either vape product or premium flower product. I think the other thing we're seeing in our data which will likely continue in the second half is innovation. Innovation is key. You've seen us launch in this quarter some innovation on our preroll business for both FloraCal and High Supply. We're very pleased with the results that we're seeing on that and their ability to drive adoption. Then, also, with our recent launch of Troches in Pennsylvania, we've been able to start to drive some considerable incremental sales in our wholesale business there as well.

So if I look to the second half of this year, the big trends that we are watching is this continued value-to-premium opportunity that exists across the portfolio, the role of innovation, which is going to continue to play a big role, but I also think the last one is that as more independent stores open up, the need for a partner to come in and help them understand what assortment is going to drive incremental margin in their stores and where velocity matters and really helping them think through how velocity and dollar per vault space [?] is going to help their total economics. So as we think of our sales team and our position as leading wholesaler, being able to partner with these independents to help them drive smarter decisions on assortment and really focus on leading brands in the best velocities is a key focus for us.

Frederico Gomes Thank you for that. Just about Michigan and the wholesale prices there, could you comment on that? What are you seeing and where do you think that's going to trend through the remainder of the year? Thank you.

Greg Butler Why don't I just pick that up as well? On Michigan, again, as Charlie mentioned earlier, we're very pleased with what our team has been able to drive in Michigan, a tough market. We are not planning on the second half of the year to see any sort of price improvement in the market. We still think, just given the structural dynamics of Michigan, that makes pricing always very volatile. We'll see what happens as we get into the second half of the year, but what we are looking at in that state is, we're able to open doors and get our products onto the independents. When we do that, we're seeing that our brands are moving. That is why you're seeing the adoption of

both the brands and our revenue growth in Michigan, because, as Charlie mentioned, the power of quality brands supported with quality products wins. So for us in Michigan, really focusing there as we get into the second half of the year is our plan.

Frederico Gomes Thank you very much. I'll hop back in the queue. Thanks.

Charles Bachtell Thank you.

Operator Thanks, Frederico. Our next question comes from Michael Lavery from Piper Sandler. Michael, your line is now open. Please go ahead.

Michael Lavery Thank you. Good morning.

Charles Bachtell Morning, Michael.

Michael Lavery You had just commented how you don't expect… Morning. You've just mentioned with respect to Michigan that you're not anticipating price improvement. That isn't a surprise. There's pressure that's either persisting in most places or maybe moderating. But could you just give a sense broadly of the pricing landscape a little bit with your efficiency and cost savings in mind as far as just what you anticipate in terms of how you try to plan for how you adjust and focus on the core? Do you expect prices to improve on any of that or at least stabilisation? So maybe a little bit of just the pricing environment from your standpoint and also how you think about that in terms of how you adjust your footprint or plan for at least the rest of the year.

Charles Bachtell Morning, Michael. Greg will handle that.

Greg Butler Morning, Michael. Back to what I was just mentioning on the previous question, we have to go into the second-half-of-the-year planning stance that we don't see price improvements. That's the most prudent thing for us to do as we head into more supply coming online in some markets, supply coming offline as capital-starved companies choose to close shop, and then also you have Croptober coming as well, which throws dynamics in the second half of the year. So our real philosophy as we plan our P&L is to assume that we're not going to see any improvements or plus side on pricing. So what that means for us and what we're focused on, one, is, how do we drive efficiency in our base business? You will see us prioritise different SKUs and different brands that have a higher margin and deprioritise SKUs, just like we've deprioritised states, that don't meet our margin threshold. So that's one big tactic we use to help in a price-flat market.

The second thing we're looking at is how price packaging and price pack architecture can help us find ways to compete and both offer unique sizing at unique pricing that's not available on the market, that we think has interesting consumer demand to it. So we're going to continue to launch price pack into the space. It helps us be both differentiated and find margin opportunities.

Then the third way that we are looking to compete is really… Pricing for us is, one, let's bring the best-quality value product to the market that competes at low pricing. You've seen that with our very successful growth of High Supply. But also find ways to bring in incremental premium pricing into the market through new forms, whether that's things like infused prerolls, whether that's the successful launch of FloraCal rosin gummies. We see an opportunity in the future where we can both compete with value brands at the lowest-cost, highest-quality offering but also supplement that with really interesting innovation where we can drive premiumisation. So all those things combined is how we really focus on driving the best overall value of wholesale in a tough pricing environment.

Michael Lavery That's helpful extra colour. Then, just where you had touched on the importance of branding at least at some point down the road, it's a new space and it's got regulations and things that create barriers to brand-building, but as far as just understanding consumer insights, are you able to do traditional CPG market research in terms of understanding what it is the consumer is looking for in certain brands? Do they associate them with brands? There certainly has been evidence of consumers shopping on just THC bang for the buck, but it seems like it's starting to be more than that. Is there work you've been able to do to understand just where the consumer's head is a little more specifically?

Charles Bachtell I'll tell you, Greg is excited to answer this question. Go ahead, Greg.

Greg Butler Sure. Thanks for the question. One is, yes, we do believe in branding. I think this thesis is proving out, particularly in markets like Illinois. Shoppers have choice and the fact that certain brands both continue having dominant share shows you that there is loyalty to brands, just like where CPG is. I think that's exciting times because that is meaning that you can really start to drive better economics of delighting those customers and consumers. You are right that from a market perspective there's still a lot of education that needs to go on to help educate consumers that are not looking to just shop on biggest bang for buck, but I also think there's lots of evidence that shows lots of brands have tried low-dosage forms that just haven't really taken off. I think that is because there is a consumer segment out there that really just does want the best value per potency. I don't think that's going to change.

Now, how we think about insights is… One of the things that is both the challenge but also probably the biggest opportunity of the cannabis space vis-à-vis traditional CPG is that the brand companies also own retail. That gives us such great insights into how shoppers are thinking about brands. We can look at consumer adoption, whether a new format drove a lot of trial but we didn't see a lot of repeat purchase, and that insight is incredibly helpful for us as we start to understand, are these brands working? Are these forms working?

Then, also, in retail you have a great channel to test new small-batch innovation with shoppers before you invest in scale. That is something that really excites us and, for someone who came from the more traditional CPG space, was always a challenge. We had to somewhat rely on consumer research, which is never as accurate as actual shopper data. That's where this industry can really leverage verticality to drive insights into what's moving, what's trending, and drive smart decisions before you launch a full-scale brand and/or take a brand into different states. I will get the

cane to get off the phone here, but I'm happy to continue this conversation later. The combination of brand and retail is really what makes this industry special for assuring that we're bringing the right products to shoppers.

Michael Lavery That's great colour. Thanks.

Operator Thanks, Michael. Our next question comes from Pablo Zuanic from Zuanic & Associates. Pablo, your line is now open. Please go ahead.

Pablo Zuanic Thank you. Charlie, you mentioned the reform front at the beginning of the conference call. I want to ask you a couple of questions there, but first, maybe if Greg can give some colour on the wholesale side of things. Sales were flat sequentially, but can you give colour in what states you might have been up or down sequentially in wholesale specifically? Then, what assumptions are you making in terms of total store count by the end of the year and end of 24? Obviously that will show the wholesale difference, but what are your assumptions there? Thank you.

Greg Butler Hey, Pablo. Let me start with that. I think Charlie will pick it up. Just state by state, one thing is, we don't tend to provide state-by-state financial, but I'll give you high-level. As Dennis mentioned, clearly on our wholesale side, markets where we deprioritised and reduced our footprint like California were obviously a sequential decline for us. As we mentioned in the earlier remarks, too, in states like Pennsylvania, where we've seen increased verticality and price compression, that has obviously created some headwinds for us in this quarter from a wholesale perspective. Then we've seen some really strong performance out of states like Michigan and Massachusetts, where we continue to ramp up our portfolio of leading brands. So combining all of that is how you're getting to the flat market. As you go to the second half of the year, we don't see a major change in that. California will still be tough because of the actions we're taking there and we also still see Pennsylvania and Illinois and other MSO-heavy markets likely are going to be tough from a wholesale perspective because of the continued vertical positioning.

Pablo Zuanic Any comments on your assumptions of store count?

Greg Butler Yes. I think, Pablo, as we look, we've been a little bit off on our thoughts on how stores were going to open for the first half of the year versus where they materialised. We expected to see more stores. We didn't see the growth in stores that we looked at. We don't publicly give information on an actual store count number, but our view is, we do not see material store ramp-ups in the second half of the year. A lot of that is due to either stores' inability to get capital to open and also stores that do open… What we're seeing is that their average purchase sizes are a lot less than we expected and a lot of that is to do with their capital positions and their ability to purchase. So, from a store perspective, second half to first half, I would say we don't think that there's going to be a material step up from the number of doors that opened in the first half.

Charles Bachtell Yes. The only thing I would add to that, too, is that in a recent conversation that was fleshed out a little bit further. It's likely that the stores that opened in 2023 were the stores that had the capital to be able to

open and therefore the stores that didn't have the capital to open are looking to divest and sell. We don't expect those will, all of a sudden, start to open in 24 unless the sale goes through. So, yes, a ramp down next year.

Pablo Zuanic Thank you. That's good colour. Charlie, in terms of the reform front, I know that it's difficult to predict, but in terms of specifically this notion that potentially Safe Harbor language for the US exchanges to allow [unclear], that that type of wording could be added to SAFE, do you see that as likely? Is there pushback from Democrats or Republicans on that or is there actually support for that among Republicans? How would you characterise those conversations in terms of exchanges, Safe Harbor language for exchanges in SAFE?

Charles Bachtell I think the way that I would characterise it is that at a certain point in the life of any proposed legislation, the policy components of it and how legislators feel about it starts to take a backseat to what will allow the bill to pass. So how I would answer this question is, there is support. There's an understanding of the need for Safe Harbor language all the way up through the US exchanges and how that is an important component of the unlock of access to capital for existing incumbents and of course for new entrepreneurs to enter the space. It all comes back to, do the legislators think that will add votes or take votes away? It really does end with… The legislators leading this initiative want SAFE to pass. So it's going to be their call on what they think they can have in there that will allow the bill to move forward and pass versus what would jeopardise it passing. Unfortunately I think we're just going to have to continue to engage. We have to continue to educate. We have to continue to make sure that they have the resources that they need in order to make the decisions that they're going to make. That's the role we're playing in it.

Pablo Zuanic Thank you. In terms of rescheduling, I notice a lot of angles to that conversation, but specifically in terms of medical rescheduling, one concern out there of mine and other people is that a can of worms could open up. You move medical cannabis to schedule three or four and then the FDA puts restrictive rules, pharmacy sale, interstate trade. Can you talk about whether you're going to have some leverage or influence in terms of what the regulatory framework around medical cannabis being descheduled would look like? Or is there not much to say or not much influence in that regard?

Charles Bachtell Well, I think we're going to continue to engage and put ourselves in position to be a trusted resource again for whether it's legislators or regulators that are going to be tasked with making those decisions. Same playbook we run at a state level. Same playbook we run at a federal level. I think the concerns over the risks of what a schedule three would create, just a personal perspective on it, I think are exaggerated. I think you've got 40 states now at this point that have their structure of either a medical or an adult use programme that they are comfortable with, that they passed laws to allow for. They've done that while cannabis is at a schedule one in the CSA. So I don't see that changing once a schedule three or higher or lower, depending on how you think about it, occurs. I think not only then will we be in a position to need to be that trusted resource for those decision-makers, but you're going to see the states be very engaged, too. Because, again, there's half a million people currently employed by the regulatory structures that currently exist. There's about $4 billion in state tax revenue on an annual basis that gets

generated from the structure that currently exists. You're going to have that stakeholder group in the room on how this looks going forward as well.

Pablo Zuanic Thank you very much.

Charles Bachtell Thanks, Pablo.

Operator Thanks, Pablo. Our next question comes from Chad Britnell from Needham. Chad, your line is now open. Please go ahead.

Chad Britnell Thanks. This is Chad Britnell in for Matt McGinley. My first question is around revenue expectations in the back half. If the asset base will be largely the same, why are you assuming revenue pressure compared to the first half? Are those pressures something that you're seeing at present or is that just providing some conservatism in the guide?

Charles Bachtell Thanks, Chad. This is Charlie. I'll start and then Dennis will jump in. I think it's a bit of a mix. While the state footprint could look the same, I think, as we've talked about prioritising the core or focusing on the core, we're going to continue to lean into the core markets and deemphasise positions in markets that are considered drags, which also could include divesting assets in those states. So all of that goes in our modelling for the second half of the year. Dennis?

Dennis Olis Yes. Just to build on that more specifically, we talked about a high single-digit drop from first half to second half on the total revenue. The bulk of that is coming from the actions that we took in California to move to a third-party distribution business and then exiting the Maryland operation in its entirety. So that has a bulk of the impact. Then we talked a little bit about the MSO and verticality that we see in certain states. That will have a little bit of an impact. Then there's always the seasonality impact that hits us in Q4. So for those reasons we are expecting a high single-digit drop in revenue from the first half to the second half of the year.

Chad Britnell Great. Thanks. Quickly, my second question is around the margin improvement that you noted for the balance of the year. Do you still expect to be at a 50% gross margin in the back half? If so, what do you think the primary drivers will be on either a state basis or from certain types of initiatives?

Greg Butler We don't give any specifics on a state basis, but despite the fact that we do expect to see a high single-digit drop in revenue, we do expect both our gross margin and adjusted EBITDA margins to improve sequentially from the first half to the second half of the year. That's being driven by the fact that we are being diligent in our investments. The actions that we took in the first half of the year to move away from dilutive operations and focusing more on accretive businesses will have an impact on our margins. Then the actions that we took at a corporate level that we did in Q1 but, more importantly, at the end of Q2… That will get the full benefit of those in the second half of the year. We do expect both gross margins and adjusted EBITDA margins to improve sequentially from the first half to the second half of the year.

Chad Britnell That's it for me. Thank you.

Charles Bachtell Thank you, Chad.