

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

You should read the following discussion and analysis of our financial condition and results of operations together with the unaudited financial information and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q, and our Annual Report on Form 10-K for the fiscal year ended December 31, 2018 (“Annual Report”). Some of the information contained in this discussion and analysis or set forth elsewhere in this Quarterly Report on Form 10-Q, including information with respect to our plans and strategy for our business and related financing, includes “forward-looking statements” within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, or “forward-looking information” within the meaning of Canadian securities laws. These statements are often identified by the use of words such as “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “project,” “will,” “would” or the negative or plural of these words or similar expressions or variations. Such forward-looking statements and forward-looking information are subject to a number of risks, uncertainties, assumptions and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by the forward-looking statements or forward-looking information. Factors that could cause or contribute to such differences include, but are not limited to, those identified in this Quarterly Report on Form 10-Q and those discussed in the section titled “Risk Factors” set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q and in our other SEC and Canadian public filings. In addition, statements that “we believe” and similar statements reflect our beliefs and opinions on the relevant subject. These statements are based on information available to us as of the date of this Quarterly Report on Form 10-Q and while we believe that information provides a reasonable basis for these statements, that information may be limited or incomplete. Our statements should not be read to indicate that we have conducted an exhaustive inquiry into, or review of, all relevant information. These statements are inherently uncertain, and investors are cautioned not to unduly rely on these statements. You should not rely upon forward-looking statements or forward-looking information as predictions of future events. Furthermore, such forward-looking statements or forward-looking information speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements or forward-looking information to reflect events or circumstances after the date of such statements.

Overview

We aspire to lead, legitimize and define the future of our industry by building the world’s most trusted and valuable cannabis company. We are pioneering the future of medical, wellness and adult-use cannabis and hemp research, cultivation, processing and distribution globally, and we intend to become a global leader in the cannabis and hemp market where regulations permit.

We produce medical cannabis in Canada and Europe, and we have supplied high-quality cannabis products to tens of thousands of patients in thirteen countries spanning five continents through our subsidiaries in Australia, Canada, Germany, Latin America, Portugal, the United Kingdom and through agreements with established pharmaceutical distributors. In Canada and Portugal, we are also authorized to distribute certain products on a wholesale basis and in Canada we also sell certain products direct to patients through our e-commerce platform or over the phone.

We are witnessing a global paradigm shift for cannabis and hemp, and as a result of this shift, the transformation of a multibillion dollar industry from a state of prohibition to a state of legalization. Medical cannabis is now authorized at the national or federal level in forty-one countries. The legal market for medical cannabis is still in its early stages and we believe the number of countries with legalized regimes will continue to increase. We believe that as this transformation occurs, trusted global brands with multinational supply chains will become market leaders by earning the confidence of patients, doctors, governments and adult consumers around the world.

We are a leader in the Canadian adult-use market. We have entered into agreements to supply certain provinces and territories with our adult-use products for sale through the distribution systems they have established. Adult-use legalization occurred in Canada on October 17, 2018 and on October 17, 2019, the Canadian adult-use regulations were amended to permit the sale of new class of cannabis including edibles, beverages and vape products, which will become available for sale starting December 16, 2019. We expect the adult-use market to represent a higher proportion of our revenues as new consumers participate in, and previously illicit consumers adopt, Canada’s framework for the sale of cannabis.

We continue to develop strategic alliances, such as our collaboration with Sandoz to increase the availability of high quality medical cannabis products, and our joint venture with Anheuser-Busch InBev, through its subsidiary Labatt Breweries of Canada, to research non-alcohol beverages containing tetrahydrocannabinol (“THC”) and cannabidiol (“CBD”), demonstrating our continuing commitment to pioneer the development of a professional, transparent, and well-regulated cannabis industry. In the third quarter of 2019, we partnered with Cannfections Group Inc., a leader in the confectionery space with 85 years of experience developing and producing the world’s favorite confectionary brands, to further build our product and manufacturing capacity of confectionery cannabis products and expedite innovation and new products to market.

On January 14, 2019, we entered into a Profit Participation Arrangement with ABG Intermediate Holdings 2, LLC (“ABG”) where we purchased: (i) participation rights in up to 49% of the net (i.e. post-expense) cannabis revenues from certain existing ABG brands into perpetuity, (ii) guaranteed minimum receipt of \$10 million annually for ten years (prorated based on total consideration paid to ABG) in quarterly payments for participation rights, (iii) preferred supplier rights of all cannabinoid ingredients for products under cannabis-related licenses of certain existing ABG brands into perpetuity, (iv) preferred royalty rates for us to license and develop cannabis products for brands currently within the ABG portfolio, and (v) first negotiation and matching rights related to participation rights in net cannabis revenues for any additional brands acquired by ABG after entering into the Profit Participation Arrangement. As consideration for this arrangement, we paid to date approximately \$33 million in cash and 1,680,214 shares of Class 2 common stock. We also agreed to pay approximately \$83 million, in a combination of Class 2 common stock and up to \$17 million in cash at ABG’s election, upon certain triggers relating to the regulatory status of THC in the United States, or receipt of \$5 million in participation rights distributions from cannabis products containing THC outside the United States, in accordance with terms outlined in the arrangement.

On February 15, 2019, we acquired Natura Naturals Holdings Inc. (“Natura”), a licensed cultivator under the Cannabis Act specializing in greenhouse cultivation. Our acquisition of Natura increases our capacity to supply high-quality branded cannabis products to the Canadian market. The preliminary purchase price of approximately \$54 million consists of approximately \$15 million in cash and 180,332 shares of Class 2 common stock issued on closing, approximately \$20 million contingent consideration based on production levels, and effective settlement of pre-existing debt and previously held interest. Refer to “Part I, Item 1. Note 15 – Business Combinations” to our financial statements appearing elsewhere in this Quarterly Report on Form 10-Q for further details.

On February 28, 2019, we acquired FHF Holdings Ltd. (“Manitoba Harvest”), a developer and distributor of a diverse portfolio of hemp-based natural food and wellness products that enables us to expand into the growing CBD product market in the United States. The preliminary purchase price of approximately \$310 million consists of approximately \$115 million in cash and 1,209,946 shares of Class 2 common stock issued on closing, approximately \$37 million in cash and approximately \$32 million in Class 2 common stock issued six months after closing, and approximately \$29 million contingent consideration based on gross branded CBD product sales in the United States in 2019. Refer to “Part I, Item 1. Note 15 – Business Combinations” to our financial statements appearing elsewhere in this Quarterly Report on Form 10-Q for further details.

On July 11, 2019, we acquired Smith & Sinclair Ltd. (“S&S”), which crafts edible candies, fragrances and creative consumables in the United Kingdom and enables us to develop CBD-infused edibles and beverages as well as alcohol-infused edibles for distribution in Canada, United States and Europe. The purchase consideration includes approximately \$2 million in cash and 79,289 shares of Class 2 common stock issued on closing, and approximately \$2 million contingent consideration based on revenue as well as the revenue and launch of CBD product in the United States and Europe or THC product in Canada by milestones in 2019 and 2020. Refer to “Part I, Item 1. Note 15 – Business Combinations” to our financial statements appearing elsewhere in this Quarterly Report on Form 10-Q for further details.

On August 28, 2019, we signed a definitive agreement to acquire 420 Investments Ltd. (“FOUR20”), an adult-use cannabis retail operator in Alberta, Canada that provides us a platform to expand into other Canadian provincial markets where Licensed Producer retail ownership will be permitted in the future. The purchase price consists of \$53 million in shares of Class 2 common stock on closing and up to \$30 million of contingent consideration subject to the achievement of certain performance milestones by FOUR20.

Key Operating Metrics

We use the following key operating metrics to evaluate our business and operations, measure our performance, identify trends affecting our business, project our future performance and make strategic decisions.

	Three months ended September 30,				Nine months ended September 30,			
	2019	2018	Change	% Change	2019	2018	Change	% Change
Kilograms equivalents sold - cannabis	10,848	1,613	9,235	573%	19,448	4,425	15,023	340%
Kilograms harvested - cannabis	15,498	5,032	10,466	208%	35,366	8,186	27,180	332%
Thousand units sold - hemp products	1,946	—	N/A	N/A	5,645	—	N/A	N/A
Average net selling price per gram - cannabis	\$ 3.25	\$ 6.21	\$ (2.96)	(48)%	\$ 4.03	\$ 6.19	\$ (2.16)	(35)%
Average cost per gram sold - cannabis	\$ 2.28	\$ 3.13	\$ (0.85)	(27)%	\$ 2.95	\$ 3.36	\$ (0.41)	(12)%
Average gross selling price per unit - hemp products	\$ 8.04	\$ —	N/A	N/A	\$ 7.29	\$ —	N/A	N/A

N/A: Not a meaningful comparison

Kilogram equivalents sold – cannabis. We sell two cannabis product categories: (1) dried cannabis, which includes whole flower and ground flower and (2) cannabis extracts, which includes full-spectrum and purified oil drops and capsules. Cannabis extracts are converted to flower equivalent grams based on the type and number of dried cannabis grams required to produce extracted cannabis in the form of cannabis oils. This conversion ratio is based on the amount of active cannabinoids in the products rather than the volume of oil. For example, our 40mL oil drops are converted to five gram equivalents.

Total kilogram equivalents sold increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to increased adult-use, bulk and international medical sales.

Kilograms harvested – cannabis. Kilograms harvested represents the weight of dried whole plants after harvest, drying and curing. This operating metric is used to measure the production efficiency of our facilities and production team.

Total kilograms harvested increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to additional operational capacity through the acquisition of Natura and ramp up of new production facilities.

The High Park Farms facility, with 13 acres of greenhouse space, has been steadily increasing production and harvest yields since its first harvest in July 2018. High Park Farms has had consistent harvest yields every month this year and total harvest quantities for this quarter increased by 607% compared to our Q4 2018 output and improved 59% since Q2 2019. Similarly, Tilray Portugal has shown steady improvement month over month since its first harvest in Q4 2018 and 154% growth improvement from Q2 2019.

It is our expectation that harvest quantities will continue to increase in future quarters with the improvement of operational efficiencies as our operational processes mature and capital expansion plans progress. During the Q2 2019, we announced plans to add 203,000 square feet at three of our existing facilities – High Park Farms, High Park Processing Facility and Tilray Canada. This expansion will increase current production and manufacturing footprint by 18% to 1.3 million square feet worldwide. This quarter, we announced additional increases for international export capacity with a new outdoor cultivation site in Portugal with Esporão, adding 20 hectares of outdoor cultivation space in Alentejo, Portugal to our existing 5 hectares of indoor and outdoor cultivation and 70,000 square feet of manufacturing, processing and research space at our European Union (EU) Campus in Cantanhede, Portugal.

Thousand units sold – hemp products. As a result of the acquisition of Manitoba Harvest, we sell hemp products such as shelled hemp seed, ground hemp, broad spectrum hemp extract containing CBD and hemp seed oil that are tracked by individual units.

This is our third quarter reporting hemp product sales and we have no sales data in the comparable periods in 2018.

Average net selling price per gram – cannabis. The average net selling price per gram is an indicator that shows our pricing trends over time on a gram equivalent basis and is impacted by sales mix, channel and product type. We exclude revenue associated with hemp products, accessories and freight sales to arrive at cannabis-related revenue. We calculate average net selling price per gram by dividing cannabis-related revenue by kilogram equivalents sold.

The average net selling price per gram decreased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 due to a shift in distribution channels and product mix. Since legalization, adult-use products increased to 32% of total revenue. Adult-use products are sold directly to wholesalers, which have lower sales price per gram and higher sales volume compared to medical channel sales. We expect our average selling price to increase over time as a result of two factors: 1) an increase in our sales mix of international medical cannabis due to GMP certifications at our Portugal facility and 2) an increase in new form factors for the Canadian adult use market that generally have higher price points. The new form factors include edible, beverage and vape products and can begin to be sold on December 16, 2019.

To determine the Canadian dollar average net selling price per gram range above, revenue and costs are converted using the average exchange rate during the reporting period. All input costs are individually converted by multiplying the U.S. dollar to Canadian dollar rate to determine the Canadian dollar amount.

Average cost per gram sold – cannabis. The average cost per gram sold measures the efficiency in our cultivation, manufacturing and fulfillment operations. We deduct hemp products, inventory adjustments and the cost of sales related to accessories from total cost of sales to arrive at cannabis-related cost of sales. Cannabis-related cost of sales is then divided by total kilogram equivalents sold to calculate the average cost per gram sold.

The average cost per gram sold decreased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily as a result of improved harvest quantities. In Q3 2018, all the product sold were from Tilray Canada, a GMP indoor grow facility, compared to three greenhouses in operation in Q3 2019. Our greenhouse operations have lower overhead costs compared to indoor operations, driving improvement in our cost per gram. Moreover, Q3 2019 was the first full quarter of operations for the High Park Processing Facility, with higher output and lower manufacturing costs compared to the temporary operation at High Park Farm used in prior quarters. Improvement in production costs during the quarter resulted in a 42% decrease in our average cost per gram from \$3.92 per gram in Q2 2019. We expect that this will continue to decrease in future quarters.

Average gross selling price per unit – hemp products. The average gross selling price per unit is an indicator that shows our pricing trends over time on a unit basis for our hemp products and is impacted by sales mix, channel and product type. We exclude revenue associated with cannabis, accessories and freight sales to arrive at hemp product-related revenue. We calculate average gross selling price per unit by dividing hemp product-related revenue by units sold.

This is our third quarter reporting hemp product activity and we have no sales data in the comparable periods in 2018.

Other companies, including companies in our industry, may calculate key operating metrics with similar names differently, which may reduce their usefulness as comparative measures.

Critical Accounting Policies and Significant Judgments and Estimates

There were no material changes to our critical accounting policies and estimates from the information provided in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” included in our Annual Report, other than those noted in “Part I, Item 1. Note 1 – Summary of Significant Accounting Policies” to our condensed consolidated financial statements (the “financial statements”) contained in this Quarterly Report on Form 10-Q. The most significant update is as follows:

Business combinations, including acquired intangibles and goodwill

We account for business combinations using the acquisition method, recording the acquisition-date fair value of total consideration over the acquisition-date fair value of net assets acquired as goodwill. The estimated fair value of acquired assets and assumed liabilities are determined primarily by using a discounted cash flow approach, with estimated cash flows discounted at a rate that the Company believes a market participant would determine to be commensurate with the inherent risks associated with the asset and related estimated cash flow streams. These estimates and the resulting valuations require significant judgment.

Results of Operations

Financial data is expressed in thousands of U.S. dollars.

Condensed Consolidated Statements of Net Loss Data

	<u>Three months ended September 30,</u>		<u>Nine months ended September 30,</u>	
	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>
Revenue	\$ 51,101	\$ 10,047	\$ 120,043	\$ 27,599
Cost of sales	35,248	6,979	86,532	16,458
Gross profit	15,853	3,068	33,511	11,141
General and administrative expense	19,978	7,001	49,240	16,488
Sales and marketing expense	16,974	3,493	39,161	9,061
Depreciation and amortization expense	3,190	529	7,438	1,032
Stock-based compensation expense	8,315	11,245	21,206	16,877
Research and development expense	2,315	802	4,891	2,416
Loss from equity method investments	1,837	—	1,837	—
Acquisition-related (income) expense, net	(13,454)	10	(6,598)	10
Operating loss	(23,302)	(20,012)	(83,664)	(34,743)
Foreign exchange loss (gain), net	2,585	(1,591)	1,153	913
Interest expense, net	8,687	480	26,018	1,393
Finance income from ABG Profit Participation Arrangement	(210)	—	(557)	—
Other income, net	(1,313)	(225)	(5,661)	(422)
Deferred income tax expense (recovery)	2,432	—	(3,987)	—
Current income tax expense	195	24	402	87
Net loss	<u>\$ (35,678)</u>	<u>\$ (18,700)</u>	<u>\$ (101,032)</u>	<u>\$ (36,714)</u>
<i>Other Financial Data</i>				
Adjusted EBITDA ⁽¹⁾	\$ (23,545)	\$ (7,353)	\$ (56,017)	\$ (15,304)

(1) Adjusted EBITDA is a non-GAAP financial measure. For information on how we define and calculate Adjusted EBITDA, and a reconciliation of net loss to Adjusted EBITDA, see “Net Loss and Adjusted EBITDA.”

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
<i>(as a percentage of revenue)</i>				
Revenue	100%	100%	100%	100%
Cost of sales	69	69	72	60
Gross profit	31	31	28	40
General and administrative expense	39	70	41	60
Sales and marketing expense	33	35	33	33
Depreciation and amortization expense	6	5	6	4
Stock-based compensation expense	16	112	18	61
Research and development expense	5	8	4	9
Loss from equity method investments	4	—	2	—
Acquisition-related (income) expense, net	(26)	N/A	(5)	N/A
Operating loss	(46)	(199)	(70)	(126)
Foreign exchange loss (gain), net	5	(16)	1	3
Interest expense, net	17	5	22	5
Finance income from ABG Profit Participation Arrangement	N/A	—	N/A	—
Other income, net	(3)	(2)	(5)	(2)
Deferred income tax expense (recovery)	5	—	(3)	—
Current income tax expense	N/A	N/A	N/A	N/A
Net loss	(70)%	(186)%	(84)%	(133)%
Other Financial Data				
Adjusted EBITDA ⁽¹⁾	(46)%	(73)%	(47)%	(55)%

(1) Adjusted EBITDA is a non-GAAP financial measure. For information on how we define and calculate Adjusted EBITDA, and a reconciliation of net loss to Adjusted EBITDA, see “Net Loss and Adjusted EBITDA.”

N/A: Not a meaningful percentage

Revenue

	Three months ended September 30,				Nine months ended September 30,			
	2019	2018	\$ Change	% Change	2019	2018	\$ Change	% Change
Adult-use	\$ 15,834	\$ —	\$ 15,834	N/A	\$ 38,756	\$ —	\$ 38,756	N/A
ACMPR (direct to patient & bulk)	13,909	9,098	4,811	53%	30,750	25,743	5,007	19%
Hemp products	15,650	—	15,650	N/A	41,167	—	41,167	N/A
International - medical	5,708	949	4,759	501%	9,370	1,856	7,514	405%
Total revenue	\$ 51,101	\$ 10,047	\$ 41,054	409%	\$ 120,043	\$ 27,599	\$ 92,444	335%
Excise tax included in revenue	\$ 2,931	\$ —	\$ 2,931	N/A	\$ 8,707	\$ —	\$ 8,707	N/A

N/A: Not a meaningful percentage

Revenue increased 409% to \$51.1 million (C\$67.8 million) and 335% to \$120.0 million (C\$159.3 million) for the three and nine months ended September 30, 2019, respectively, compared to revenue of \$10.0 million and \$27.6 million (C\$13.0 million and C\$35.5 million) for the same periods in 2018, respectively. The acceleration in growth was primarily driven by the Canadian adult use market, which began in October of 2018, the acquisition of Manitoba Harvest during the first quarter of 2019, and the acceleration of international medical sales as a result of our Portugal facility receiving its GMP certification. We expect continued growth in these markets for the remainder of 2019.

We welcomed Manitoba Harvest to our portfolio of companies on February 28, 2019. Manitoba Harvest is the world’s largest hemp food manufacturer and a leader in the natural foods industry, producing, manufacturing, marketing and distributing a broad-based portfolio of hemp-based (cannabis) consumer products sold in over 16,000 stores at major retailers across the United States and Canada. Manitoba Harvest also launched a line of CBD products in the United States in 2019, which are available in over 500 locations.

Revenue from international medical sales grew more than five times of the comparative periods in 2018, driven by Tilray Portugal's first export of cannabis flower to Cannamedical Pharma GmbH to supply patients in Germany, which contributed \$3.0 million of revenue in Q3 2019. This was enabled by the EU Campus in Portugal that is a GMP certified, multi-faceted production facility with indoor, outdoor and greenhouse cultivation sites. Increasing our presence in the international markets is a strategic priority for us and we believe we are well positioned to serve International markets from Portugal as more countries legalize medical cannabis.

Our cannabis extract products revenue was \$5.8 million and \$16.2 million (C\$7.7 million and C\$21.5 million), for the three and nine months ended September 30, 2019, respectively, compared to \$5.2 million and \$12.7 million (C\$6.7 million and C\$16.4 million) for the same periods in 2018, respectively. On a percentage of revenue basis, extract products accounted for 17% and 21% of revenue from non-hemp products for the three and nine months ended September 30, 2019, respectively (2018 – 52% and 46%). The launch of the adult-use market in Canada and contributed \$15.8 million (C\$21.0 million) and \$38.8 million (C\$51.4 million) to our revenue, representing 31% and 32% of revenue for the three and nine months ended September 30, 2019, respectively.

ACMPR (direct to patient & bulk) includes bulk sales of \$10.0 million and \$21.5 million for the three and nine months ended September 30, 2019, respectively. Bulk sales are expected to significantly decrease in the future.

The Canadian dollar revenue was derived using the average exchange rate during the reporting period. Amounts are individually converted by multiplying the U.S. dollar to Canadian dollar rate to determine the Canadian dollar amount.

Cost of Sales and Gross Profit

	Three months ended September 30,				Nine months ended September 30,			
	2019	2018	\$ Change	% Change	2019	2018	\$ Change	% Change
Cost of sales	\$ 35,248	\$ 6,979	\$ 28,269	405%	\$ 86,532	\$ 16,458	\$ 70,074	426%
Gross profit	15,853	3,068	12,785	417%	33,511	11,141	22,370	201%
Gross profit percentage	31%	31%			28%	40%		

Cost of sales increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to greater sales, the addition of our acquisitions of Manitoba Harvest and Natura, the start-up of High Park Farms and Portugal, and a shift towards a mix of high THC and high CBD cultivars that have lower yields.

Gross profit percentage remained relatively consistent for the three months ended September 30, 2019 from the comparable period in 2018 despite the change in product mix from 2018 primarily due to benefits of economies of scale for our new cultivation facilities and processing facilities. Gross profit percentage decreased for nine months ended September 30, 2019 from the comparable period in 2018 primarily due to procurement of third-party supply, low yields, and low throughput during the scaling of new facilities impacting us in the first half of the year. In the second quarter of 2019 our High Park Processing Facility came online, allowing us to discontinue the temporary set up in High Park Farms, this location had higher costs and lower output than the Processing Facility. Moreover, the gross profit on hemp products was impacted by a non-cash charge due to the one-time purchase accounting step-up in inventory value in the amount of \$2.0 million for the six months ended June 30, 2019.

During 2019, we improved throughput and increased efficiencies due to our new facilities. As a result, our gross profit percentage has improved sequentially since the first quarter of 2019, from 23%, to 27%, to 31%. Gross profit percentage is also impacted by product and sales channel mix, with higher valued products and international medical being the highest margin and low value added and bulk wholesale being the lowest margin.

Operating Costs and Expenses

	Three months ended September 30,				Nine months ended September 30,			
	2019	2018	Change	% Change	2019	2018	Change	% Change
General and administrative expense	\$ 19,978	\$ 7,001	\$ 12,977	185%	\$ 49,240	\$ 16,488	\$ 32,752	199%
Sales and marketing expense	16,974	3,493	13,481	386	39,161	9,061	30,100	332
Depreciation and amortization expense	3,190	529	2,661	503	7,438	1,032	6,406	621
Stock-based compensation expense	8,315	11,245	(2,930)	(26)	21,206	16,877	4,329	26
Research and development expense	2,315	802	1,513	189	4,891	2,416	2,475	102
Loss from equity method investments	1,837	—	1,837	N/A	1,837	—	1,837	N/A
Acquisition-related (income) expense, net	(13,454)	10	(13,464)	N/A	(6,598)	10	(6,608)	N/A
Total operating expenses	<u>\$ 39,155</u>	<u>\$ 23,080</u>	<u>\$ 16,075</u>	<u>70%</u>	<u>\$ 117,175</u>	<u>\$ 45,884</u>	<u>\$ 71,291</u>	<u>155%</u>
(as a percentage of revenue)								
General and administrative expense	39%	70%			41%	60%		
Sales and marketing expense	33	35			33	33		
Depreciation and amortization expense	6	5			6	4		
Stock-based compensation expense	16	112			18	61		
Research and development expense	5	8			4	9		
Loss from equity method investments	4	—			2	—		
Acquisition-related (income) expense, net	(26)	N/A			(5)	N/A		
Total operating expenses	<u>77%</u>	<u>230%</u>			<u>98%</u>	<u>166%</u>		

N/A: Not a meaningful percentage

General and administrative expense increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to higher employee costs to support a larger business from the acquisition of Manitoba Harvest, increases in professional fees related to legal, audit and human resources, IT services to support our growth, and public company costs. During the three and nine months ended September 30, 2019, we incurred \$1.5 million and \$2.3 million of non-recurring costs respectively. During the three months ended September 30, 2019 we expanded corporate offices, increasing our occupancy costs by \$1.0 million

Sales and marketing expense increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to the acquisition of Manitoba Harvest, development of our Canadian adult-use sales and marketing team, and the development of our European leadership team with five senior appointments last quarter, as we expand our international presence. In three months ended September 30, 2019, High Park developed a comprehensive portfolio of new brands and products for next phase of the adult-use market. The expanded broad-based portfolio includes innovative cannabis products and formats, including edibles, vape products and CBD beverages.

Depreciation and amortization expense increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to the acquisitions of Manitoba Harvest and Natura in 2019, contributing \$2.5 million and \$5.7 million of the increase for the three and nine months ended September 30, 2019, respectively.

Stock-based compensation expense decreased for the three months ended September 30, 2019 from the comparable period in 2018 primarily due to unusually high stock-based compensation expense in three months ended September 30, 2018, as a result of our initial public offering (“IPO”) and the related stock options, restricted stock units and certain IPO contingency triggers related to performance-based awards under the New Plan. Stock-based compensation expense increased for the nine months ended September 30, 2019 from the comparable period in 2018 due to the issuance of stock options and restricted stock units granted under the New Plan for more employees to support a larger business.

Research and development expense increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to our continued support in advancing cannabinoid-based science to further understand the potential benefits of medical cannabis as a treatment. During the quarter, we supported two new clinical research studies with NYU School of Medicine. The two studies will test the efficacy of CBD to treat patients suffering from alcohol use disorder (“AUD”) and patients suffering from AUD comorbid with post-traumatic stress disorder (“PTSD”). We expect our research and development expense to increase as we pursue more clinical trial opportunities and continue to invest in developing non-combustible delivery formats and formulations.

Acquisition-related (income) expense resulted in income for the three months ended September 30, 2019 from the comparable period expense in 2018 due to a change in fair value of contingent consideration for the acquisitions of Manitoba Harvest and Natura based on actual results to date and forecasts for the remainder of the earn-out periods. The reductions in the fair value of contingent consideration offset acquisition related expense incurred during the quarter. Acquisition-related expense increased for the nine months ended September 30, 2019 from the comparable period in 2018 primarily due to costs incurred to close and integrate the acquisitions of Manitoba Harvest and Natura.

Foreign Exchange (Loss) Gain, Net

The impact of foreign exchange for the three and nine months ended September 30, 2019 was a loss of \$2.6 million and \$1.2 million, respectively, compared to a gain of \$1.6 million and a loss \$0.9 million for the comparable periods in 2018. As we hold a significant portion of balances in Canadian dollars, the fluctuation in foreign exchange rates between Canadian dollars and U.S. dollars drove the foreign exchange loss in both the three and nine months ended September 30, 2019.

Interest Expense

Interest expense for the three and nine months ended September 30, 2019 was \$8.7 million and \$26.0 million, respectively (2018 – \$0.5 million and \$1.4 million). The increase was primarily attributable to the issuance of \$475.0 million in Convertible Notes in October 2018. We expect an increase in interest expense in 2019 to reflect a full year of expense related to the Convertible Notes.

Net Loss and Adjusted EBITDA

	Three months ended September 30,				Nine months ended September 30,			
	2019	2018	Change	% Change	2019	2018	Change	% Change
Net loss	\$ (35,678)	\$ (18,700)	\$ (16,978)	91%	\$ (101,032)	\$ (36,714)	\$ (64,318)	175%
Adjusted EBITDA	\$ (23,545)	\$ (7,353)	\$ (16,192)	220%	\$ (56,017)	\$ (15,304)	\$ (40,713)	266%

Adjusted EBITDA reconciliation:	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Net loss	\$ (35,678)	\$ (18,700)	\$ (101,032)	\$ (36,714)
Depreciation and amortization expense	4,686	1,404	10,441	2,552
Stock-based compensation expense	8,315	11,245	21,206	16,877
Acquisition-related (income) expense, net	(13,454)	10	(6,598)	10
Foreign exchange loss (gain), net	2,585	(1,591)	1,153	913
Interest expense, net	8,687	480	26,018	1,393
Other income, net	(1,313)	(225)	(5,661)	(422)
Amortization of inventory step-up	—	—	2,041	—
Deferred income tax expense (recovery)	2,432	—	(3,987)	—
Current income tax expense	195	24	402	87
Adjusted EBITDA	<u>\$ (23,545)</u>	<u>\$ (7,353)</u>	<u>\$ (56,017)</u>	<u>\$ (15,304)</u>

Net loss increased for the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to an increase in operating expenses related to continued growth, expansion of our international teams, interest expense from the Convertible Notes, and results of the Manitoba Harvest and Natura businesses acquired.

Adjusted earnings before interest, tax and depreciation (“Adjusted EBITDA”) decreased in the three and nine months ended September 30, 2019 from the comparable periods in 2018 primarily due to an increase in operating expenses related to continued growth as well as expansion and development into new markets.

To supplement our financial statements, which are prepared and presented in accordance with U.S. generally accepted accounting principles (“GAAP”), we use Adjusted EBITDA, as described below, to understand and evaluate our operating performance. Adjusted EBITDA, which may be different than similarly titled measures used by other companies, is presented to help investors’ overall understanding of our financial performance and should not be considered a substitute for, or superior to, the financial information prepared and presented in accordance with GAAP.

Adjusted EBITDA should not be considered in isolation from, or as a substitute for, net loss. There are a number of limitations related to the use of Adjusted EBITDA as compared to net loss, the closest comparable GAAP measure. Some of these limitations are that:

- Adjusted EBITDA excludes certain recurring, non-cash charges such as depreciation and amortization expense and, although these are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future;
- Adjusted EBITDA excludes stock-based compensation expense, which has been, and will continue to be for the foreseeable future, a significant recurring expense in our business and an important part of our compensation strategy;
- Adjusted EBITDA excludes third-party acquisition and integration expenses and changes in the fair value of contingent consideration, which are considered non-recurring, to reflect normal business activity;
- Adjusted EBITDA excludes foreign exchange gains or losses, which account for the effect of both realized and unrealized foreign exchange transactions. Unrealized gains or losses represent foreign exchange revaluation of foreign denominated monetary assets and liabilities;
- Adjusted EBITDA excludes interest expense, which has been, and will continue to be for the foreseeable future, a significant recurring expense in our business and reduces cash available to us;
- Adjusted EBITDA excludes the non-recurring, non-cash impact of the amortization of purchase accounting step-up in inventory value, to reflect normal business activity; and
- Adjusted EBITDA excludes current and deferred income tax expense and recovery, which could be a significant recurring expense or recovery in our business in the future and reduce or increase cash available to us.

Liquidity and Capital Resources

As of September 30, 2019, we had cash and cash equivalents of \$100.2 million and short-term investments totaling \$22.2 million which were held for working capital purposes. Our cash, cash equivalents and short-term investments consist primarily of cash, treasury bills and corporate bonds.

In February and March 2018, we issued 7,794,042 shares of Series A preferred stock at \$7.10 per share in exchange for cash proceeds of approximately \$55.0 million from third-party institutional investors. On our IPO, all shares of the outstanding Series A preferred stock automatically converted into 7,794,042 shares of Class 2 common stock on a one-for-one basis.

In July 2018, we completed our IPO, whereby 10,350,000 shares of our Class 2 common stock were sold at a price of \$17.00 per share, which included 1,350,000 shares sold pursuant to the underwriters' option to purchase additional shares. We received net proceeds of approximately \$163.7 million after deducting the underwriting discount.

In October 2018, we entered into an indenture relating to the issuance of \$475.0 million aggregate principal amount of 5.00% Convertible Notes, which included \$25.0 million pursuant to the underwriters' option to purchase an additional aggregate principal amount. Net proceeds from the issuance were approximately \$460.8 million, after deducting the initial purchasers' commissions.

In September 2019, we entered into a sales agreement with Cowen and Company, LLC that enables us to issue and sell shares of Class 2 common stock from time to time up to an aggregate offering price of \$400.0 million through an "at-the-market" equity offering program. During the three months ended September 30, 2019, we issued 1,344,166 shares of Class 2 common stock for gross proceeds of approximately \$38 million under the program.

Our primary need for liquidity is to fund working capital requirements, capital expenditures, debt service obligations and for general corporate purposes. Our ability to fund operations and make planned capital expenditures and debt service obligations depends on future operating performance and cash flows, which are subject to prevailing economic conditions and financial, business and other factors.

The following table sets forth the major components of our Condensed Consolidated Statements of Cash Flows for the periods presented:

	Nine months ended September 30,	
	2019	2018
Net cash used in operating activities	\$ (167,255)	\$ (26,440)
Net cash used in investing activities	(264,844)	(53,544)
Net cash provided by financing activities	45,098	179,667
Effect of foreign currency translation on cash and cash equivalents	(95)	2,239
(Decrease) increase in cash and cash equivalents	<u>\$ (387,096)</u>	<u>\$ 101,922</u>

The change in net cash used by operating activities primarily related to changes in working capital fluctuations and changes in non-cash expenses, all of which are highly variable.

The change in net cash used in investing activities primarily related to our acquisitions of Manitoba Harvest and Natura, investment in the ABG Profit Participation Arrangement, and purchase of property and equipment related to our expansion projects in Canada and Portugal.

The change in net cash provided by financing activities primarily related to proceeds from our “at-the-market” equity offering program, exercise of stock options, and ABG Profit Participation Arrangement.

The table below sets out the cash and cash equivalents, short-term investments and inventory:

	September 30, 2019	December 31, 2018
Cash and cash equivalents	\$ 100,159	\$ 487,255
Short-term investments	22,213	30,335
Inventory	110,487	16,211

We primarily financed our operations through the issuance of common stock, sale of Convertible Notes and revenue generating activities. We believe that our existing cash will be sufficient to meet our working capital requirements.

We manage our liquidity risk by preparing budgets and cash forecasts to ensure we have sufficient funds to meet obligations. In managing working capital, we may limit the amount of our cash needs by selling inventory at wholesale rates, pursuing additional financing sources and managing the timing of capital expenditures. While we believe we have sufficient cash to meet working capital requirements in the short term, we may need additional sources of capital and/or financing, to meet planned growth requirements and to fund construction activities at our cultivation and processing facilities.

Contractual Obligations

As a result of the acquisitions of Manitoba Harvest and Natura, contractual operating lease obligations of the Company increased by approximately \$0.3 million from December 31, 2018. The Company has contractual commitments relating to contingent consideration for the acquisitions of Manitoba Harvest and Natura as well as the ABG Profit Participation Arrangement subject to certain regulatory or commercial triggers. Refer to “Part I, Item 1. Note 15 – Business Combinations” and “Part I, Item 1. Note 14 – ABG Profit Participation Arrangement” to our financial statements appearing elsewhere in this Quarterly Report on Form 10-Q for further details. In addition, the Company entered into various purchase obligations that require future minimum contractual commitments of approximately \$172.9 million as of September 30, 2019.

Emerging Growth Company Status

We are an “emerging growth company” as defined in Section 2(a) of the Exchange Act, as modified by the Jumpstart Our Business Start-ups Act of 2012, or the JOBS Act. The JOBS Act provides that an emerging growth company can take advantage of the extended transition period provided in Section 13(a) of the Exchange Act for complying with new or revised accounting standards applicable to public companies. We have elected to take advantage of this extended transition period and as a result of this election, our financial statements may not be comparable to companies that comply with public company effective dates.

We will no longer be able to take advantage of this exemption beginning on December 31, 2019, when we will be deemed a large accelerated filer and, as a result, cease to be an “emerging growth company.”

Off-Balance Sheet Arrangements

We did not have during the periods presented, and we do not currently have, any off-balance sheet arrangements, as defined in the rules and regulations of the SEC.

Recently Issued Accounting Pronouncements

A description of recently issued accounting pronouncements that may potentially impact our financial position and results of operations is disclosed in “Part I, Item 1. Note 1 – Summary of Significant Accounting Policies” to our financial statements appearing elsewhere in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

There have been no material changes to our market risk disclosures as set forth in Part II Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2018.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively), evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2019. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, or DCPs, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. DCPs include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based on the evaluation of our DCPs, our Chief Executive Officer and Chief Financial Officer concluded that, due to a previously reported material weakness, the Company’s internal control over financial reporting was not effective as of September 30, 2019. A material weakness is a deficiency, or combination of control deficiencies, in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act), or ICFR, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. Specifically, our inventory cost calculations and the financial close processes are manual in nature such that a timely, sufficiently precise and detailed review to mitigate the risk of material misstatement is not currently feasible due to the complexity of the spreadsheet-based models used. There were no material errors in the financial results or balances identified, no restatements of prior period financial statements, and no changes in previously released financial results were required as a result of this control deficiency.

Remediation Efforts to Address Material Weakness

As previously described in Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2018, the Company began implementing a remediation plan to address the material weakness mentioned above. Management will continue to increase the depth and experience within our operations, accounting and finance organizations, and design and implement improved processes and internal controls with the intent of increasing the use of system-based processes to limit manual calculations and adjustments in the inventory costing and financial close processes. The material weakness will not be considered remediated until the applicable controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively.

Changes in Internal Control over Financial Reporting

Other than with respect to the remediation efforts described above, there have been no changes in the ICFR during the three months ended September 30, 2019 that have materially affected, or are reasonably likely to materially affect, the Company’s ICFR.