

**Recommendation: Buy (S)**  
**Target Price: \$4.20**

## \*Aphria Inc. (APH-TSXV)

### *Solid Quarter Of Growth & Profits*

Current Price	\$3.57	Shares Outstanding (MM)	
52 Wk High	\$4.04	Basic	90.2
52 Wk Low	\$0.88	Diluted (ITM)	103.3
		Mgmt. & Dir.	24.2
Debt (MM)	\$7.7	Market Cap. (MM)	\$322.1
Cash (MM)	\$51.4	Float (MM)	\$235.8
		EV (MM)	\$275.6

Fiscal YE May 31		2016A	2017E	2018E
Gram Sales (kg)	Q1	120	585 A	846
	Q2	256	599	947
	Q3	322	643	1,029
	Q4	340	749	1,117
	<b>FY</b>	<b>1,039</b>	<b>2,576</b>	<b>3,939</b>
Dollar Sales (MM)	Q1	\$1.0	\$4.4 A	\$6.5
	Q2	\$2.0	\$4.6	\$7.4
	Q3	\$2.7	\$5.3	\$8.0
	Q4	\$2.8	\$6.4	\$8.7
	<b>FY</b>	<b>\$8.4</b>	<b>\$20.6</b>	<b>\$30.6</b>
EBITDA (MM)*	Q1	-\$0.4	\$1.1 A	\$2.2
	Q2	-\$0.3	\$1.3	\$2.5
	Q3	\$0.4	\$1.5	\$2.9
	Q4	\$0.5	\$2.0	\$3.2
	<b>FY</b>	<b>\$0.2</b>	<b>\$5.9</b>	<b>\$10.8</b>
Sales y/y chg.			144%	49%
EBITDA y/y chg.			NM	85%
EV/EBITDA*			47.1x	25.5x

\* EBITDA excluding amortization & biological asset adj. in COGS

### Company Description:

Aphria is a licensed commercial producer supplying Canada's legal MMJ (medical marijuana) market. Operations are based in Leamington, Ontario and are being scaled-up to serve the growing MMJ market and the much larger RMJ (recreational marijuana) market post legalization (RMJ market tracking to open during 2018).

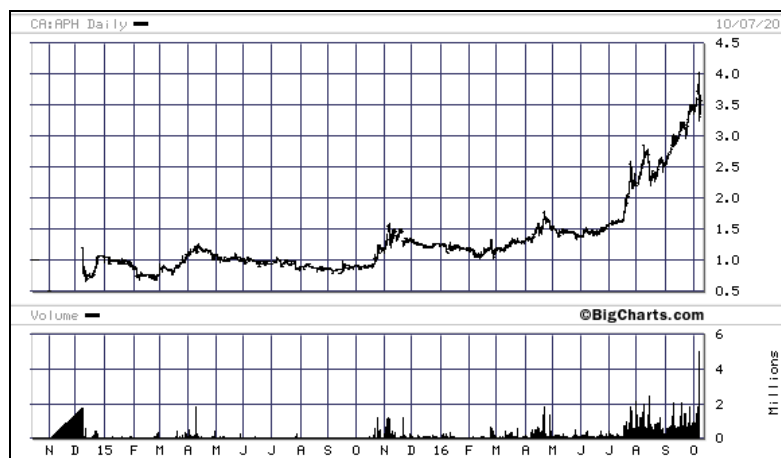
Unless otherwise denoted, all figures shown in C\$

### Investment Thesis:

APH has differentiated itself as the low-cost producer in the sector with an exclusive greenhouse approach to growing. Operations have already reached profitable status and profits are poised to ramp-up as the company executes substantial capacity expansions going forward to supply the rapidly growing MMJ market and the potentially much larger RMJ market post legalization.

### Highlights:

- Top Line Growth Continues, Profits Already Emerging**  
 APH posted impressive Q/Q momentum as the company benefits from solid execution in the greenhouse alongside aggressive MMJ market demand growth. The quarter is highlighted by sales of \$4.4 MM (up 58% Q/Q) and EBITDA of \$1.1 MM (up 102% Q/Q). We estimate FCF (op. CF less maintenance capex) at \$1.3 MM, or \$0.8 MM excluding working capital inflows.
- Ongoing Profit Ramp-Up In The Cards**  
 With APH already posting profits and with substantial capacity expansions on the horizon, we continue to think the company is poised to aggressively ramp-up profit levels. The outlook is also supported by sector trends, including rapid expansion of the MMJ market size (some data provided in this note) and lengthy licensing timelines for new commercial producers (leaving existing producers well positioned to maintain/grow market share).
- Maintaining Buy (S) Rating & \$4.20 Target**  
 Quarterly results do not trigger a change to our target/rating or our view of steady state earnings potential that feeds our target valuation, as detailed in this note.



Source: BigCharts.com, October 7, 2016

◆ During the past twenty-four months, Cormark Securities Inc., either on its own or as a syndicate member, participated in the underwriting of securities for Aphria Inc.

Our disclosure statements are located on the second last page of this report

**FQ1/17 Summary.** APH posted impressive Q/Q momentum as the company benefits from solid execution in the greenhouse alongside aggressive demand growth from the MMJ market (updated Health Canada data provide below). With APH already posting profits and with substantial capacity expansions on the horizon, we continue to think the company is poised to aggressively ramp-up profit levels and drive an ongoing re-rating of the stock to more accurately reflect run-rate earnings levels post growth of the MMJ market and post opening of the substantially larger RMJ market. We are maintaining our Buy (S) rating and \$4.20 target.

**Figure 1: APH Quarterly Results**

Fiscal year May 31	Q1/16	Q2/16	Q3/16	Q4/16	Q1/17			
	Actual	Actual	Actual	Actual	Actual	Est. Ch. Q/Q	Ch. Y/Y	
Gram sales (kg)	120	256	322	340	585	541	72%	389%
Dollar sales (\$MMs)	\$1.0	\$2.0	\$2.7	\$2.8	\$4.4	\$4.5	58%	360%
Realized price (\$/g)	\$7.95	\$7.91	\$8.31	\$8.16	\$7.48	\$8.36	-8%	-6%
Cash costs to produce (\$/g) <sup>(1)</sup>	\$2.13	\$1.87	\$1.67	\$1.15	\$1.23	\$1.25	7%	-42%
Adj. cash cost of sales (\$/g) <sup>(2)</sup>	\$2.41	\$2.04	\$1.83	\$1.35	\$1.37	\$1.50	1%	-43%
All-in costs of sales (\$/g) <sup>(3)</sup>	\$3.25	\$2.49	\$2.22	\$2.08	\$1.80	\$1.93	-13%	-45%
Adj. gross profit (\$MMs) <sup>(4)</sup>	\$0.7	\$1.5	\$2.1	\$2.3	\$3.6	\$3.7	54%	440%
Adj. gross margin %	69.7%	74.3%	77.9%	83.4%	81.7%	82.1%	-	-
EBITDA (\$MMs)	-\$0.4	-\$0.3	\$0.4	\$0.5	\$1.1	\$1.6	102%	NM
EBITDA margin %	-40.6%	-15.3%	15.8%	18.8%	24.1%	35.6%	-	-

(1) APH metric: cost of sales per gram sold, ex. non-cash bio. asset adj., amortization, and packaging costs.

(2) Cormark metric: Cash costs to produce from above, but including packaging costs.

(3) APH metric: cost of sales per gram sold, ex. non-cash bio. asset adj. (includes amortization and packaging).

Source: Company filings, Cormark Securities

### Quarterly highlights and company updates:

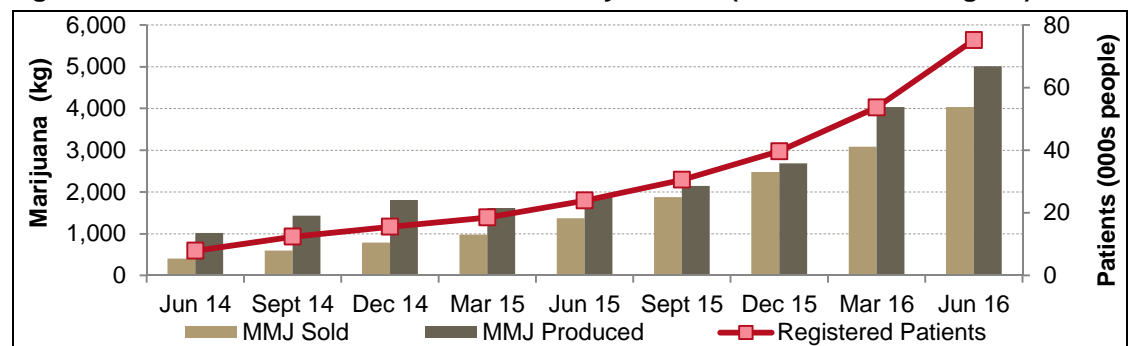
- **Top line:** gram sales were up 72% Q/Q driven by patient onboarding (including success adding more clinic platform across the country) and what we suspect was growth of wholesale shipments to peer producers (fits with recent sector commentary we have received suggesting some producers are facing production issues/constraints). An uptick in the wholesale portion of the sales mix likely explains the pricing per gram decline (down 8% Q/Q), leading to a dollar sales increase of 58% Q/Q. On a gram sales basis, we estimate APH holds MMJ market share of ~10-11% (vs. ~9-10% last quarter).
- **Profit lines:** cost per gram metrics as outlined in Figure 1 still qualify APH as the low cost producer in the sector and meaningful profits have already started to emerge at the current early stage of production capacity buildout. Growing costs ("cash costs to produce") of \$1.23/g are well below year-ago levels and should continue trending towards the \$1.00/g level as capacity ramps up and new greenhouse technologies potentially boost yields. Adj. gross profit of \$3.6 MM (excluding the amortization in the company reported \$3.3 MM) supports gross margins of 82% and this line item was in line with our forecast. EBITDA of \$1.1 MM supports margins of 24% and was lower than our estimate as overheads ramped-up ~3-6 months faster than modelled to support capacity and sales growth.
- **Expansion plans & balance sheet:** capacity expansions remain on track to service the growing MMJ (and eventual RMJ) market, with capacity moving from the current 2,500-3,000 kg/year to 5,500-6,000 kg/year by exit-C2016 (the Part 2 expansion) and to 18,000-19,000 kg/year by late-C2017 (first part of the Part 3 expansion that will ultimately take capacity to 60,000-70,000 kg/year, implying ~10% market share using our MMJ+RMJ market size forecast). The milestone dates quoted above reflect completion

of the physical builds, prior to Health Canada license amendments (2-4 months) and the first grow cycle (up to 4 months). The buildouts remain funded with cash flow, the \$51 MM cash balance (adjusted for subsequent events post the last balance sheet date) and long-dated debt remains low at \$7.7 MM.

**Checking-In On The Sector Backdrop.** The publicly traded commercial producers continue to trade higher and we attribute the performance to ongoing growth of the MMJ market, reflection of additional value associated with the approaching RMJ legalization opportunity, and emerging levels of profitability among some of the commercial producers. Some notable data points:

- **MMJ market still in hyper growth mode:** updated Health Canada data indicates MMJ sector growth to exit-June 2016 of 30% Q/Q for gram sales, 157% Q/Q for oil sales and 40% Q/Q for patient registrations (Figure 2). Patient registrations also continued to grow in July (up 10% M/M), taking total registrations to 82,217 individuals (up from 24,000 in mid-2015 and up from 43,000 in early-2016). Penetration still remains well below our MMJ market size forecast calling for 425,000 patients and annual gram equivalent sales of 85,000 kg.
- **Licensing timelines for new entrants:** we are hearing that timelines for obtaining a commercial production/sales license is now up to three years for new players. While timelines are not a permanent barrier to entry, we think the lengthy timeline is positive for producers that are already active with room to scale up at existing locations and capture/maintain market share as the MMJ sector grows and as the RMJ market starts to open (likely during 2018 based on current government timeline goals). On this theme, ♦Mettrum's (MT-V, Buy(S), \$4.55 target) recent sale of its non-core Bennett Road North facility highlights the value of having a licensed facility already in place – Bennett Road North (installed and licensed capacity 500 kg/year; land/building is leased) was sold for \$7 MM, equating to \$14/g of licensed capacity that is materially higher than the \$0.85-1.25/g we estimate is needed to develop new greenfield capacity.

**Figure 2: Total MMJ Market Sales/Production By Quarter (Under ACMPR Regime)**



Source: Health Canada

**Maintaining Buy (S) Rating & \$4.20 Target.** Quarterly results do not trigger a change to our target/rating or our view of steady state earnings potential that feeds our target valuation (Figure 3). Our target for APH (and all companies we cover in the sector) includes 100% of the value we attribute to the base case scenario stemming from active capacity expansion plans and sales into only the MMJ market, plus 25% of the incremental value we attributed to the scenario with full capacity buildouts and sales into the much larger MMJ+RMJ market. On the back of recent share price rallies for the entire sector (including APH up 179% YTD), we estimate ~15% of the RMJ upside scenario is now priced-into APH's share price, with 18% upside left to our target price. We may start layering-in more upside value as the RMJ opportunity gets further re-risked, likely starting with the Task Force update in November/December 2016 that will help clarify regulations and the extent of economic opportunities available for commercial producers.

♦ During the past twenty-four months, Cormark Securities Inc., either on its own or as a syndicate member, participated in the underwriting of securities for Mettrum Health Corp.

**Figure 3: APH Target Price Buildup**

<b>1. Value Of Base Case Capacity Plan With MMJ Market Only</b>	
Capacity (post base case expansion; kg/year)	19,000
Capacity utilization for MMJ (% of total)	65%
Implied market share (% of mature MMJ market)	14.2%
<b>Steady State EBITDA Buildup</b>	
Realized pricing (\$/g)	\$6.55
Cash costs (\$/gram)	\$1.43
Implied gross margin (%)	78%
Overheads (G&A, S&M, other; % of sales)	35%
Implied EBITDA margin	43%
Steady state EBITDA target (\$MMs)	\$34.9
<b>Target Value Buildup</b>	
Target EV/EBITDA	7.0x
Target EV	\$244.4
Target equity value (\$MMs)	\$288.1
Target equity value discounted 3 yrs (\$MMs)	\$238.1
FD ITM, fully financed, shares o/s (MMs)	103.2
Target value (\$/share)	<b>\$2.31</b>
Return from current share price	-35%
<b>2. Incremental Value Of Expansion Optionality With MMJ+RMJ market</b>	
Capacity (post full buildout potential; kg/year)	60,000
Capacity including unallocated capacity from base case (kg/year)	47,650
Implied mkt. share (% of mature MMJ+RMJ market)	13.0%
<b>Steady State EBITDA Buildup</b>	
Realized pricing (\$/g; wholesale structure assumed)	\$5.00
Cash costs (\$/gram)	\$1.43
Implied gross margin (%)	71%
Overheads (G&A, S&M, other; % of sales)	25%
Implied EBITDA margin	46%
Incremental steady state EBITDA target (\$MMs)	\$110.5
<b>Incremental Target Value Buildup</b>	
Target EV/EBITDA	7.0x
Incremental value to equity (\$MMs)	\$773.8
Buildout capex equity financed (\$MMs)	\$15.0
Incremental diluted target value (\$/share)	<b>\$7.20</b>
<b>3. Final Target Price Buildup (\$/share)</b>	
Target value from base case capacity plan	\$2.31
% of expansion option value included	25%
Target value from expansion optionality	\$1.80
<b>Target price</b>	<b>\$4.20</b>
% upside to target	19%

Source: Cormark Securities, Company filings

We, Kyle McPhee and Mike Brown, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject company(ies) and its (their) securities. We also certify that we have not been, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

**Aphria Inc.**

Updated October 07, 2016

**Price Chart and Disclosure Statement**

\*Information updated monthly on or about the 5th of each month.



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Buy or Top Pick	62%
Market Perform	17%
Reduce	2%
Not Rated	20%

\*Over the past 24 months, the following percentage of issuers whose securities received a "Top Pick" or "Buy", a "Market Perform", or a "Reduce" rating from Cormark Securities Inc., have engaged Cormark to provide investment-banking services during this period.

Buy or Top Pick	48%
Market Perform	20%
Reduce	20%

Recommendation / Target Chg  
Date C\$  
02-Sep-16 4.20 (B-S)

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**Mettrum Health Corp.**

Updated October 07, 2016

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Recommendation / Target Chg	
Date	C\$
02-Sep-16	4.55 (B-S)
02-Sep-16	4.55 (Chng Cover)
17-May-16	- (U.R.)
07-Oct-14	4.00 (B-S)

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<b>Buy</b>	expected to outperform its peer group
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Additionally, our target prices are set based on a 12-month investment horizon.

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