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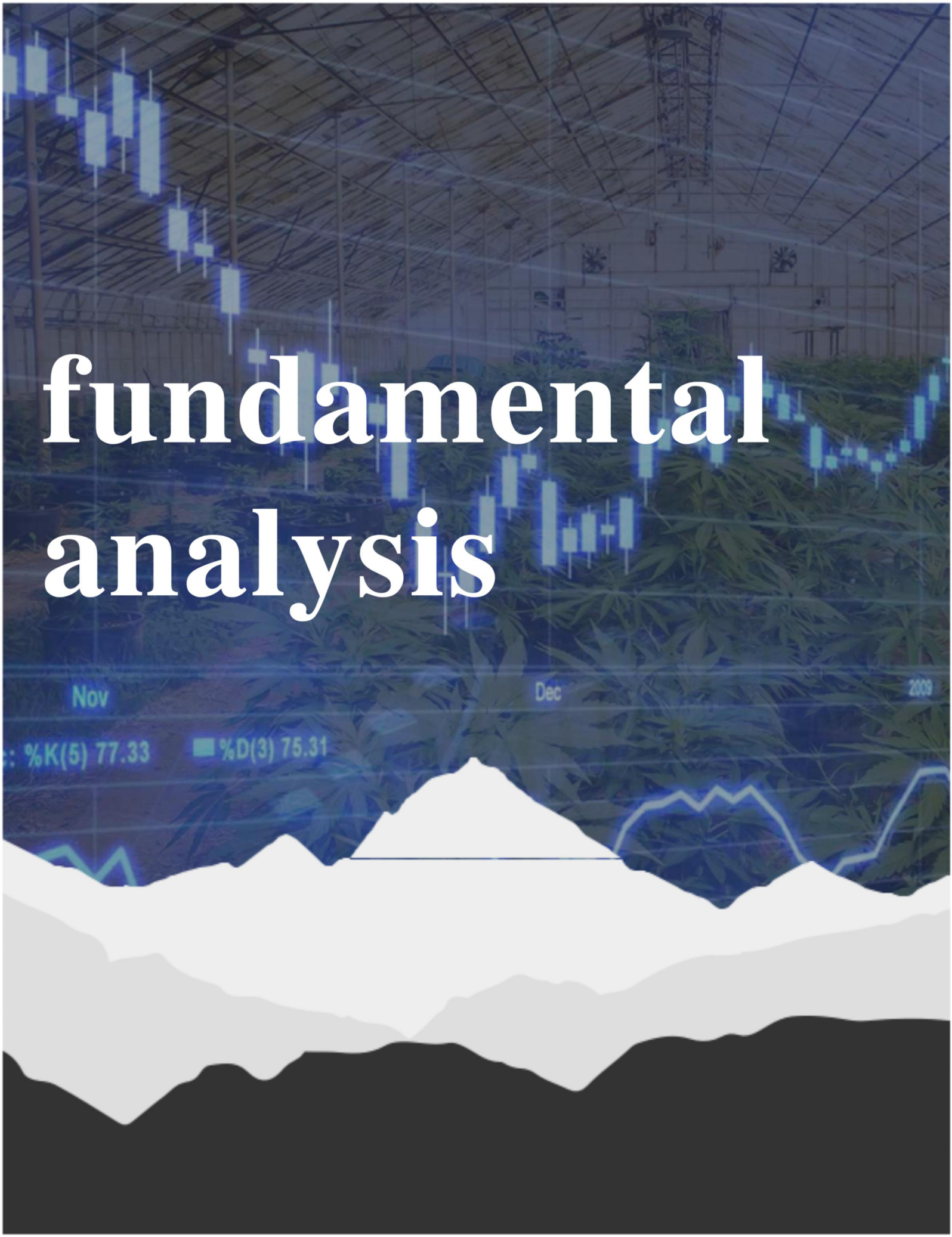
YOUR CANNABIS INVESTMENT RESOURCE

Q4 2019

the cannin report

Your Cannabis investment resource.

fundamental analysis



Risks Disclosures

If you are considering investing in a company that is connected to the marijuana industry, be aware that marijuana-related companies may be at risk of federal, and perhaps state, criminal prosecution. The Department of Treasury recently issued guidance noting: "[T]he Controlled Substances Act ("CSA") makes it illegal under federal law to manufacture, distribute, or dispense marijuana. Many states impose and enforce similar prohibitions. Notwithstanding the federal ban, as of the date of this guidance, 20 states and the District of Columbia have legalized the certain marijuana-related activity."

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Cresco Labs Inc.

Fundamentals

Profile:
HQ: Chicago, IL, USA
Founded: 1990
Facilities: Chicago, Joliet, Lincoln, Fall River, Salome, Las Vegas, San Luis Obispo, Mendota, others
Symbol: CRLBF (OTC); CL (CSE)

Focus: Strong
As a top-quality cannabis producer, processor and retailer operating in seven US states, the company focuses on entering highly regulated markets with excessive demand potential and high barriers to entry. Cresco has elevated everyday cannabis through its THC-forward products available in flower, vape pens, and multiple forms of extracts.

Cresco plans to leverage the success in Illinois, Pennsylvania, Ohio, Nevada, California, and Arizona to expand into legalized cannabis markets in other states, while focusing on compliance, control, efficiency, and product performance in the medicinal or adult-use cannabis industry. Currently in the process to complete the application process for new states beginning or expanding medical cannabis programs such as Florida, Michigan, and New Jersey, etc.

Size:
Market Cap: US $ 691.23 mil
Enterprise value: $ 820.45mil
Size among cultivators: 7th of approximately 40
Number of Employees: 500

Markets: Strong
Primary: Operations in 7 states (Illinois, Ohio, Penn., Nevada, California, Arizona, and MA)
Secondary: Approval pending in 3 additional states (NY, MA, and Maryland).

Operations: Strong
Cultivation:
Current production: 113,500 pounds per year (as of Feb. 2019)
Future production: 447,500 pounds per year (by Dec. 2019)

Their current facility features a 23,294-square-foot, state-of-the-art greenhouse separate from the 26,445-square-foot area where the marijuana is processed**.** Their expansion in Lincoln, brings nearly 140,000 square feet of total cultivation at the three Illinois facilities, tripling their previous capacity.

It is expected that 40-50% of the raw cannabis produced at Cresco's production facilities (except for raw cannabis produced in Pennsylvania and New York) will be used at Cresco's kitchens and laboratories to make the vaporizable, oral and topical and edible products sold under the Cresco, Reserve, Remedi, and Mindy's brands.

Direct sales: No
Store networks: 21 retail licenses, a medical marijuana dispensary in Elmwood Park, opened two dispensaries in New York and first legal sale of medical marijuana in the state of Ohio in Jan 2019.

Supply agreements: On December 6th, 2018, Cresco Labs announced a definitive agreement to acquire 100% membership interests of Hope Heal Health, based in Massachusetts with licenses for cultivation, processing, and the ability to obtain up to three medical marijuana dispensary licenses and three adult-use dispensary licenses. On December 20th, 2018, Cresco Labs announced that it had signed dual definitive agreements to acquire licensed Illinois medical cannabis dispensaries MedMar Rockford and MedMar Lakeview bringing our total number of dispensaries in Illinois to five.

Registered patients: 404,000 by Feb 2019.

Integration/Diversification: Neutral
Vertically integrated: Yes.
Horizontally diversified: Not yet.

Financials: Strong
Previous Year Revenue: $100.66 mil
Outstanding shares (diluted): 36.12mil
QoQ Revenue Increase: 257.47%
EPS: ($0.18)

Management: Strong
CEO & Director: Charlie Bachtell
CFO: Ken Amann
President and Director: Joseph Stevens Caltabiano
Vice Chairman: Brian Thomas McCormack

Branding:
Cresco utilizes a multi-brand approach to product development. The brand "Cresco" features THC-focused products available in flower, vape pens, and multiple forms of extracts. Each product falls into one of three proprietary categories: “Rise”, “Refresh”, “Rest”, named and color-coded to help the user intuitively identify the desired effects of the relevant strain's cannabinoid profile. "Mindy's Artisanal Edibles" and "Mindy's Kitchen" are brands created in collaboration with James Beard Award-Winning Chef Mindy Segal and are the industry's first true culinary-backed edible option. Both of Mindy's lines are lauded for their unique flavor profiles. "Reserve" products are made from Cresco's most premium and exclusive plants and are the reward of years of selective breeding. "Remedi" products are designed for the medically-minded patient, with forms reminiscent of traditional pharmaceuticals.

Valuation: Strong
Current share price: US $5.07
Price to Sales: 5.51 (Tobacco industry = 5)
52 week low/high: US $4.47 - 14.39
EV/Revenue: 8.15
Price/Book: 3.82

Financing: Neutral
Series D funding round securing $100 million (US)
Successfully raised $205 million in growth capital through three capital raises in 2018

Risks: Neutral
The risks of investing in any cannabis company are currently high given the newness of the market. The risks of investing in this company are less so given their multi-state presence and strong focus.

Recommendation: Strong
As a differentiated grower, processor and retailer of premium cannabis with operations in six states (Illinois, Ohio, Pennsylvania, Nevada, California, and Arizona) and approval pending for acquisitions in three more states (New York, Massachusetts, Maryland), the company focuses on entering markets with outsized demand potential, significant supply constraints and high barriers to entry. Cresco Labs is on track to become one of the largest major producers of cannabis very soon with its aggressive growth strategy. They focus on entering highly regulated markets with excessive demand potential and high barriers to entry. It also has plans to expand internationally.

We believe the company has strong management, based on experience in cannabis, compliance and market growth. Cresco is one of a very small group of operators to successfully obtain cultivation licenses in more than one of the modern, limited license, merit-based application state programs.

We think their cultivation capacity is very impressive. The production capacity is expected to grow three times by the end of this year while seeking distribution licenses in key US states. However, with aggressive growth in production, they need to increase distribution channels to avoid a buildup of large inventories. Their growth strategy is based on targeting expansion in states like Florida, New Jersey, Virginia, and Connecticut.

Management is pursuing growth by increasing market share and entering new markets. Will its stock price improve in the long term? We think so. Cannabis stock prices usually reflect expected future revenue, not current revenue.

Cresco labs showed exceptional growth with year-to-date revenue of $25.1 million (up 248% from the prior year) and third-quarter net income of $3.9 million, compared to a net loss of $0.2 million in the prior-year period. We would like to see their gross margins increase from 40% to above 50% (a level many of their competitors have achieved).

With $93.9 million cash in hand, they have sufficient financial bases to do more acquisitions, to expand to new markets, and add new distribution channels. That being said, with total liabilities of $9.3 million and total assets of $149.4 million, they are an ideal target of acquisition by larger companies. At the same time, they have one of the highest market cap/revenue ratios among all of the U.S. cannabis companies.

For these reasons, we think Cresco labs, at or near its current price of $8.26 a share, is still a very good investment opportunity—though as the price rises this opportunity will eventually disappear.

Pesticide Use in Cannabis Cultivation

"Pesticides" is an ugly word with (usually) a negative connotation, and the last thing we want to do is to be ingesting them through cannabis use. But just like any other plant, cannabis is susceptible to the insects and diseases that pesticides fight against. We don't want to be ingesting spider mites and fungus, either.

Every other agricultural product has certain pesticides that are made specifically for them, and they are relatively safe if used correctly by following the instructions. But what about cannabis? Are there specific pesticides made for the growing industry that has been projected to produce almost $132 billion in tax revenue and 1 million jobs?

Unfortunately, the answer to that question is no. There is no special pesticide made explicitly for cannabis due to disparities between state and federal laws. This means that there are no approved pesticides for cannabis, and that has left the growers with no choice but to take matters into their own hands using methods and pesticides that are intended for other uses.

On the bright side, the cannabis industry has noticed this informal use of pesticides and, as a result, safer methods are being examined and spread throughout agricultural commerce. In places like California and Colorado, where recreational marijuana use has been legalized, lists of safer forms of pesticides have been produced. In these places, biological methods such as the use of citric acid, sulfur, and bio-pesticides, have replaced chemically dependent pesticides. These methods use microorganisms and natural chemicals to fight against insects, pests, and fungi.

According to Marrone Bio Innovations, not only are these naturally produced pesticides usable for every type of crop out there, they are safer for the environment, safer for human health, and safer for the crops they are used on. This discovery of bio-pesticide use could completely replace the old chemical way of doing things. This means that the cannabis industry has not only grown exponentially, it has also had a positive effect on other agricultural fields that could lead to higher crop yields and safer consumption.

Before bio-pesticides became the more commonly used pesticides in cannabis cultivation, chemical pesticides and herbicides were raising health concerns. To top that off, many of the pesticides being used were unauthorized because there were no guidelines or approved pesticides for what was/is considered an illicit crop by the federal government. Unauthorized in this case means industrial strength chemicals that, in some cases, are banned. Fortunately, in states that cannabis has been legalized, officials have drafted rules on safe pesticides for the crop. Regulating pesticide use has been and continues to be a struggle for cannabis companies because of the federal laws governing the topic, however, because it is still considered an illicit crop, finding safe pesticides can be an expensive endeavor and regulations can only be put in place if the studies and research needed can be done. It is an uphill battle for cannabis companies who, until recently, have not had to worry about widespread fungus and spider mites in the much larger operations that have been developed.

Why is Revenue Generation Important for Publicly Traded Companies?

Publicly traded companies have performance indicators that investors base investment decisions on. Revenue, and the continuance of further revenue generation, is one of the most important indications of a successful company that investors focus on in earnings releases and gather peace of mind from. The importance of revenue generation is that it shows if a company's performance has stagnated from previous quarters with previous quarter comparisons, quarter-over-quarter comparisons, and year-over-year comparisons. A company's revenue generation is also widely tied to the demand for its product or services and their ability to market them correctly. Lastly, if a company can't generate enough revenue for consistent profits, then it will not effectively scale to capture more and more of its market space as time passes.

The net income of a publicly traded company is garnered through its revenue and is then utilized to determine the Earnings Per Share (EPS). An earnings release and EPS of a company that shows an increase in revenue and profits heavily influence the value of the stock as it indicates the company's ability to continue revenue growth and generate a profit. Investors tune in to earnings releases quarterly to find out how the company fared in revenue generation and find out the new EPS numbers. If a company has significantly higher earnings than predicted it will promote vigorous interest by outside investors who decide to invest due to the indication that profits will continue company growth and further continue increased revenue generation.

When a company is required to release its financial earnings quarterly, all of its finances are revealed to the public. These earnings releases are what current and potential investors will use to dictate if they should increase their current position with the company or to close their position with the company in fear of further losses. The line between if a company has demand for its product and the ability to continue sales and revenue growth will be very apparent with comparisons to previous quarters within the same year. If a company shows a decline in revenue generation with missed earnings predictions through three straight quarters, then it will be taken by investors as a sign that the company's lack of stellar revenue generation will not waver.

A company's ability to generate a larger revenue and continual profit within the market space that it occupies weighs greatly on the company's performance in the next quarter. There is a compounding effect if a company misses one or more quarters in a row and continues to not generate enough revenue to make a profit. A company will have significantly less cash on hand to expand and capture a larger percentage of its market from its competitors or first-time buyers in new regions if it fails to generate enough revenue. If a company doesn't generate a profit and has tapped out of its cash reserves, then it will have to get financed for a debt facility that comes with repayments and interest which will most likely further take away from its quarterly profits. The debt facility, or credit loan, would serve the company as a way to continue routine operations, scale the company up into new regions, expand marketing for its services or products, and swing the company back into the black with further revenue generation.

Revenue generation is highly important for companies as it is required to ease current investors, attract new investors, scale the business up, and maintain cash flow. It is not only important for companies to generate consistent amounts of revenue; they also need to generate more revenue after every quarter to demonstrate effective growth. Investors will take notice of a quarterly increase to revenue generation and determine if a company can continue to lead itself into a higher position within its market or further cement itself as a market leader.