



## 3 Things You Didn't Know About Aphria's (TSX:APHA) Latest Earnings

### Description

The strong rebound in **Aphria** (TSX:APHA)(NYSE:APHA) earnings from a \$108 million quarterly loss in February 2019 to a \$15.8 million net profit in May after a nearly 75% sequential jump in revenue and some margin expansions was a big surprise to the market to justify a 40% one-day jump in the stock price.

A massive revenue growth, an unexpected swing back to net profitability, and a historic return to positive adjusted EBITDA before the other big pot stock peers are strong positives that redeem the company's previously tainted image and had the power to lift Aphria's industry peers, too.

Almost every other important earnings metric in the latest earnings release was pleasing, but there were some startling details that Mr. Market could have easily forgiven while celebrating the big news.

Let's look at just three today.

### A breach of financial covenants for the year

The company's latest Management Discussion and Analysis (MD&A) reads that "the company was in breach of its debt service ratio loan covenant for the year, however (it) obtained a waiver from calling the loan from this breach prior to year-end." Management expects to meet the covenant during this new financial year.

Such a news piece could have caused significant alarm under different circumstances.

If the company had not [received a critical licence update](#) for its flagship Aphria One facility that allowed it to quickly ramp up production, increase inventory levels, and enabled it to double its cannabis sales volumes, things could have been different.

The company believes that it has sufficient operating room with respect to its financial covenants for the next fiscal year and does not anticipate being in breach of any of its financial covenants during this period. It's okay to believe management on this; the business is growing big and has become recently

profitable.

It's also okay to just acknowledge there was a breach that could have resulted in a sudden loan call back, potentially causing damaging ripple effects on the balance sheet.

## **A tricky change in cost of sales computation**

Accounting is an art (at times), and management can make some nice reporting changes if the rules permit.

The company's "all-in" cost of sales per gram calculation was recently tweaked in the company's favour.

"During the quarter, the company identified selling costs previously reported as distribution costs and included as part of the 'all-in' cost of sales of dried cannabis per gram..." and reclassified these costs to selling, marketing, and promotion.

This move reduced prior quarter all-in costs by nearly \$2.4 million and reduced the all-in cost of sales per gram of dried cannabis by 24% from \$3.76 to \$2.86.

Therefore, Aphria's latest cost of sales reading before fair-value adjustments may show significant cost-profile improvements, which are artificially higher than they could have been had management maintained the old classification method. It's likely that the latest \$2.35 per gram all-in cost of sales measure could have been 31.5% higher before the reporting change.

That said, there's no standardized way to compute the all-in cost of sales metric for the industry, but it's important to note that cost of sales accounting has the potential to affect the gross margin — and this measure expanded recently!

## **Increased uncertainty on key assets**

Management seems increasingly uncertain over the potential licensing timelines on the company's biggest facility, which is linked to another key production asset.

Aphria Diamond, the company's jointly owned 1,300,000-square-foot grow facility and the highly esteemed Extraction Centre of Excellence, which is expected to process over 200,000 kilograms of cannabis per annum, are both facing a worrisome licensing delay.

The state-of-the-art Extraction Centre of Excellence is "physically located on the same property as Aphria Diamond and requires Aphria Diamond's licence to submit a licence amendment application with Health Canada," explains the latest MD&A.

The company initially applied for a production licence for the long-completed Diamond grow facility back in March 2018, and today, 16 solid months later, the facility is yet to be licensed, but engagements with Health Canada continue. Management is making contingent plans at its licensed facilities to supplement extraction capacity. This is expensive.

Licensing issues are costing the company significantly in lost opportunities, and that's concerning. **Aurora Cannabis** has been [very good at getting such licences](#) faster.

## Foolish bottom line

Aphria had an otherwise great quarter, and this could be the beginning of many profitable quarters in the years ahead given the latest earnings guidance for impressive revenue growth to \$700 million in fiscal 2020 and strong positive adjusted EBITDA.

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