Cash Going Up in Smoke

We put Cronos Group Inc. (CRON: $3/share) in the Danger Zone in October 2019. Since our report, the stock has outperformed the S&P 500 as a short by 97%. Even after falling 86% from its 2019 high and 29% year-to-date, we think the stock has much more downside.

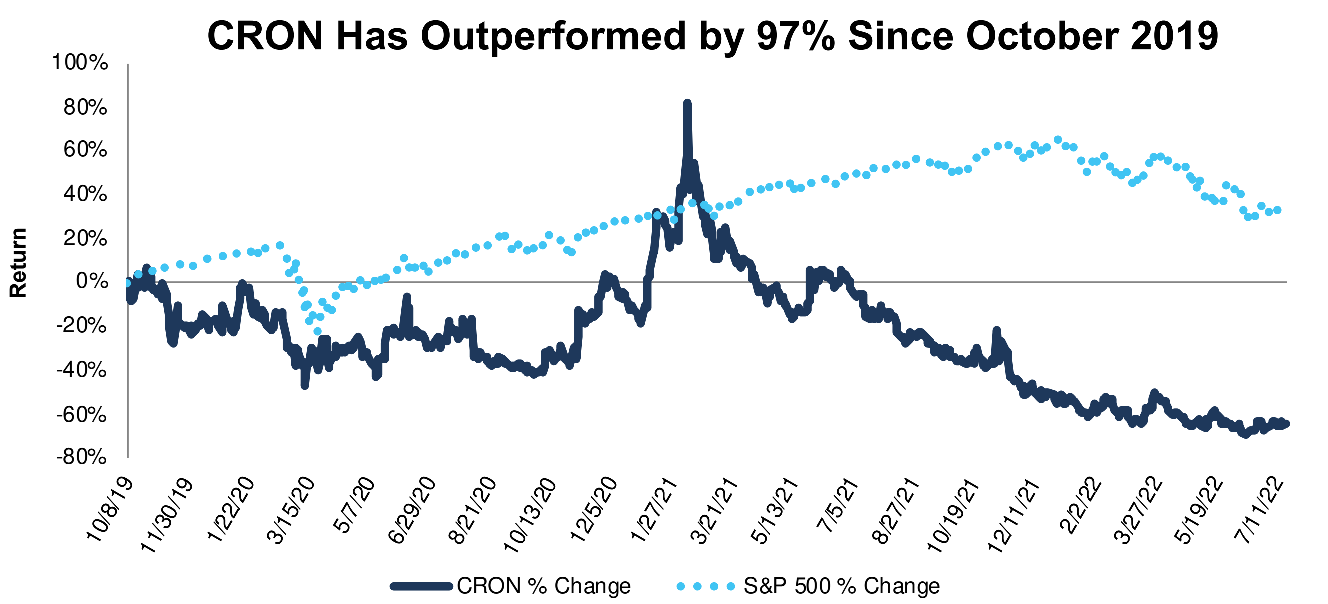
This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior fundamental research and support more cost-effective fulfillment of the fiduciary duty of care[1].

Cannabis stocks experienced a bubble and a burst in 2019, then staged a false rally in 2021 that has left prices falling for the past fifteen months. After a burnout like that, one might expect to find deals galore, and value investors are shopping the sector in earnest. Even after large declines, betting on these companies beating the expectations baked into their stocks' prices isn't for the sober minded. We warn investors against entering these value traps (look forward to more on this topic) until the industry experiences a wave of consolidation and the smoke has cleared.

CRON Is Still Risky Based on the Company's:

- profitless growth
- cash-burning business
- stock could be worth as little as $1/share

Figure 1: Performance: From Date of Publication Through 7/18/2022



Sources: New Constructs, LLC

Why We're Keeping Cronos in the Danger Zone

Given the issues we highlighted in our original report such as Cronos' misleading GAAP earnings and non-GAAP metrics, unsustainable revenue growth rates, poor profitability, lack of scale, and expensive valuation of its stock, the stock's underperformance comes as no surprise.

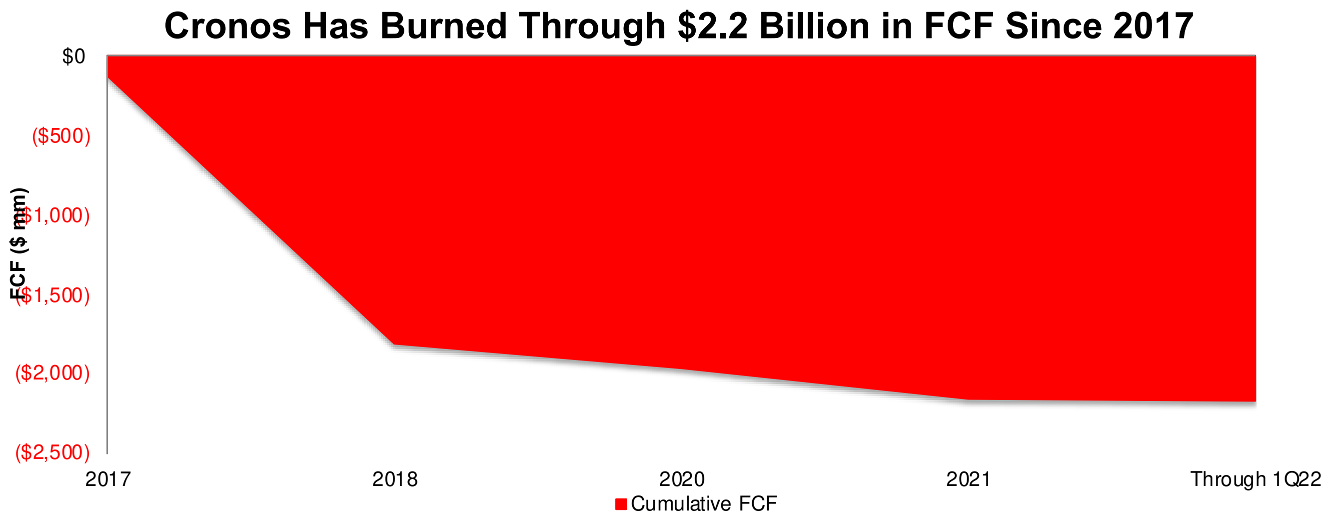
[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

As anticipated, Cronos' year-over-year (YoY) revenue growth rate has significantly slowed from 258% in 2018. The company's trailing-twelve-month (TTM) revenue rose just 74% in 1Q22. Even more concerning for the company is its deteriorating profitability. Cronos' Core Earnings fell from -$7 million in 2017 to -$168 million over the TTM.

The company's return on invested capital (ROIC) has fallen from -8% in 2019 to -10% TTM. Cronos' falling ROIC drove its economic earnings from -$173 million to -$298 over the same time.

Cronos' operation is also a significant cash burner. Per Figure 2, since 2017, the company has burned -$2.2 billion (2x its current market cap) in free cash flow (FCF). As we've recently shown with zombie stocks like Carvana (CVNA), Freshpet (FRPT), and Peloton (PTON), companies that burn through cash are extremely risky in this market environment.

Figure 2: Cronos' Cumulative Free Cash Flow: 2017 – 1Q22



Sources: New Constructs, LLC and company filings

Reverse DCF Math: Cronos' Shares Have Further to Fall

Below we use our reverse discounted cash flow (DCF) model to analyze the future cash flow expectations baked into Cronos' stock price. We also provide an additional scenario to highlight the downside potential in shares if Cronos' revenue grows at more reasonable rates.

If we assume Cronos':

- net operating profit after tax (NOPAT) margin immediately improves to 10% (more than double the 4% margin of farming companies under coverage[2], compared to Cronos' -173% margin in fiscal 2021,
- revenue grows at 56% in 2022 and 38% in 2023 (equal to consensus), and
- revenue grows 24% compounded annually from 2024 – 2031, then

the stock would be worth $3/share today – equal to the current stock price.

In this scenario, Cronos would generate $1.1 billion in revenue in 2031, which is 11x its TTM revenue and 12x its 2021 revenue.

Keep in mind, the number of companies that grow revenue by 20%+ compounded annually for such a long period are "unbelievably rare", making the expectations in Cronos' share price outright unrealistic. In a more realistic scenario, detailed below, the stock has large downside risk.

[2] Farming companies include Alico (ALCO), Cal-Maine Foods (CALM), Corteva (CTVA), Fresh Del Monte Produce (FDP), Limoneira Company (LMNR), Phibro Animal Health Corp (PAHC), SiteOne Landscape Supply (SITE), and The Andersons (ANDE).

CRON Has 67%+ Downside if Consensus Is Right

We perform a second DCF scenario to highlight the downside risk to owning Cronos should it grow at consensus revenue estimates. If we assume Cronos':

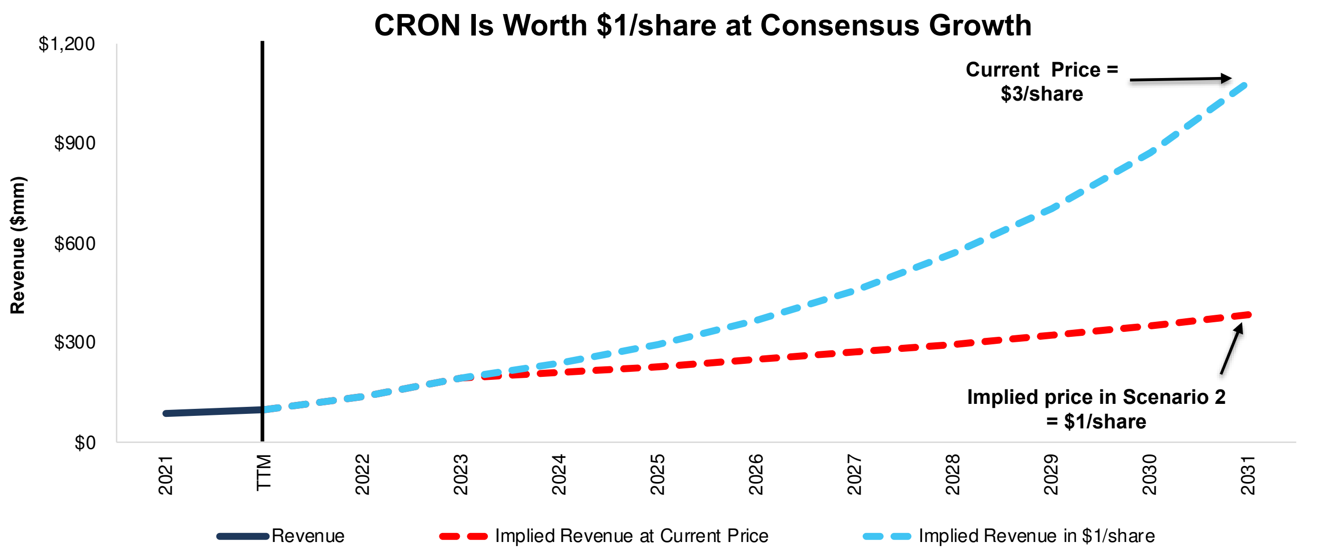
- NOPAT margin improves to -5% in 2022, 0% in 2023, 5% in 2024, and 10% from 2025 – 2031,
- revenue grows at consensus rates in 2022 and 2023, and
- revenue grows 9% a year in 2025-2031, then

the stock would be worth just $1/share today – a 67% downside to the current price. This scenario still implies Cronos' revenue grows to $386 million in 2031.

If Cronos fails to achieve the revenue growth or margin improvement we assume for this scenario, the downside risk in the stock would be even higher.

Figure 3 compares Cronos' historical revenue to the revenue implied by each of the above DCF scenarios.

Figure 3: Cronos' Historical and Implied Revenue: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings.

Each of the above scenarios also assumes Cronos grows revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is highly unlikely but allows us to create best-case scenarios that demonstrate the expectations embedded in the current valuation. For reference, Cronos' invested capital has increased 118% compounded annually since 2017. If we assume Cronos' invested capital increases at a similar historical rate, the stock's downside risk is even larger.

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Disclosure: David Trainer, Kyle Guske II, Matt Shuler, and Brian Pellegrini receive no compensation to write about any specific stock, style, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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