Trickle Research

Every raging river, every great lake, every deep blue sea starts … with a trickle

# Q1-F23Earnings Update

# Vext Science, Inc.

**(symbol: VEXTF)**

**www.vextscience.com**

## Report Date: 06/01/23

## 12- 24 month Price Target: US$1.35

## Allocation: 7

**Closing Stock Price at Initiation (Closing Px: 01/30/20): US$.55**

**Closing Stock Price at Allocation Upgrade (Closing Px: 06/02/20): US$.33**

**Closing Stock Price at Allocation Upgrade (Closing Px: 07/13/21): US$.67**

**Closing Stock Price at Allocation Upgrade & Target Decrease (Closing Px: 01/11/23): US$.21**

**Closing Stock Price at This Update (Closing Px: 05/31/23): US$.20**

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**Trickle Research**

**Disclosure:** Portions of this report are excerpted from Vext's filings, website(s), presentations or other public collateral. We have attempted to identify those excerpts by *italicizing* them in the text. Unless otherwise noted, all prices in this report are in US Dollars.

For Q1F23 VEXT reported revenue of $9.1 million versus our estimate of $8.5 million. However, our estimate did not include any contribution from the consolidated Ohio dispensary because we generally like to see the reported consolidation before we start speculating on what it might look like. The MD&A reflects that VEXT consolidated $1.24 million of Ohio dispensary revenue and $487,000 of Ohio dispensary gross profit. When we reflect that in our prior 1QF23 projections, our estimates for Arizona Q1F23 revenues were overstated by about $600,000. Moreover, there were some additional items that impacted our bottom-line assessments, which we will cover here, but suffice it to say, the Company continues to face headwinds in Arizona that include both macro-economic issues (less discretionary consumer spending) as well as continued supply imbalances in the Arizona cannabis market, which (as we have lamented along the way) are in our view related in part to regulators inability to control black market forces that are compromising the legal side of the cannabis market in a number of states including Arizona.

Specifically, VEXT reported a pre-tax loss of $1.1 million versus our estimate of a pre-tax gain of $447,000, or a difference of about $1.45 million. While that is a bit stark, especially considering prior reporting surprises (or lack thereof), there were some extraordinary items that drove a good portion of the difference. First, the operating statement reflects specific non-operating line items as follows:

| | |
|---|---|
| Change in fair value of debt | - (190,984) |
| Debt transaction costs | - (742,036) |

Those items were related to adjustments around the debt associated with (and ultimately the consolidation of) the Ohio assets. Again, these largely represent non-cash and non-recurring items, so if we back them out the above earnings miss, moves from $1.45 million to $614,000.

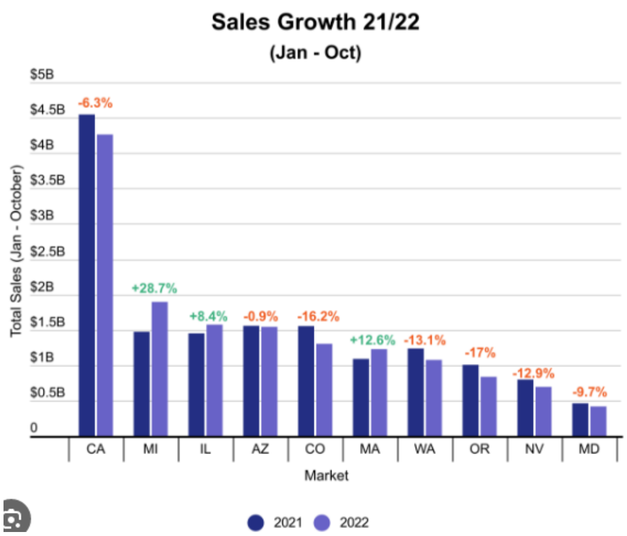
In addition to the Ohio debt adjustments, one of the other line items where we had a meaningful miss was in cost of goods sold related to Arizona. For instance, while we projected Arizona revenue of $8.48 million and gross profit of $5.36 million, or a margin of 63%, actual numbers for Arizona were revenues of $7.87 million and gross margin of $4.16 million or 53%. However, as the narrative from the MD&A notes below reflect, the Company took a charge of $712,000 *"to the cost of goods in the first quarter in relation to biological assets"* and related to the *"idling of outdoor cultivation in Prescott Valley"*. They also note relative cost savings should be realized in Q2F23, which we have attempted to reflect in our model. Here again, if we back out this item, actual relative pre-tax income would have been about $100,000 greater than our model assessments. Our point here is not to suggest that some of these extraordinary items do not matter, but rather to point out that we continue to view the Company as operating successfully and within the parameters we have established in our model assumptions albeit within the constraints of a challenging environment. That brings us to our next point.

As we noted, the Company has faced some headwinds of late that are largely related to the state of the cannabis industry in Arizona. As the Company recent MD&A reflects: "*According to the revenue collection data reported by the State of Arizona, the market experienced a 15% decrease in sales through February 2023 compared to the same period of 2022. We expect this trend to continue when the March numbers are released. The main factor contributing to the decline is the financial pressure faced by consumers, resulting in reduced discretionary income available.*

*Despite not setting the market trend, our retail operations experienced less reduction in top line than reported in the overall market. We continue to see an increase in customers and transactions, although the average basket size has declined due to customers having less discretionary income due to inflation and participating more in the adult use market. Operating expenses in the dispensary have remained steady, even with increased transactions, allowing us to maintain our margin percentages.*

*In line with the third and fourth quarters of 2022, the wholesale markets in Arizona faced ongoing pressure. The market expansion following Arizona's legalization of adult use in late 2020 led to increased cultivation capacity. Consequently, there is now excess capacity and supply that has created significant downward price pressure.*

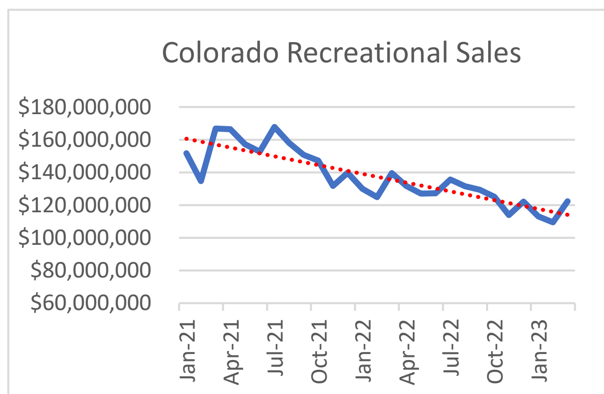
*Some cultivators lease licenses from dispensary owners, do not own retail fronts and are therefore more subjected to market supply pricing pressure. Additionally, certain dispensary operators expanded their cultivation capacity beyond their ability to sell the product through their own dispensaries, relying on the wholesale market to support the increased production. Recognizing this trend, Vext management has taken appropriate action to ensure that we only produce what can be sold through our stores and do not enter the wholesale flower market in Arizona. As part of this strategy, we decided to idle the outdoor cultivation in Prescott Valley in the first quarter 2023, resulting in cost savings that will be reflected in the second quarter expense line The idling of the outdoor grow operation contributed to a $712,000 charge to the cost of goods in the first quarter in relation to biological assets. Previously incurred costs were charged back. Some of this charge will be one time in nature.*




The above noted, to be clear, weakness is also being experienced in several other, especially more mature recreational cannabis use states. For instance, Axios https://www.axios.com/local/san-francisco/2023/03/01/sluggish-cannabis-sales-california recently noted:

*Retail cannabis sales in California declined 8.3% last year (2022) for the first time since becoming legal in 2018, according to data released last week. Experts say the revenue decline is the result of* ***deep-seated issues with the state's legal weed market*** *and the voter-approved Proposition 64, which promised all adults in California access to safe cannabis. In San Francisco, cannabis sales dropped from $260.6 million in 2021 to $228.8 million in 2022 — a 12.2% decline.*

*Other markets like Washington and Colorado saw sales declines as well in 2022,* ***indicating broader economic factors could be at play,*** *Nicole Elliott, California's director of the Department of Cannabis Control, told Axios.*




To edify, the narrative above regarding California's sales declines imply that proposition 64 is partially to blame for California's sales declines, while they also alluded to broader economic factors. Moreover, we agree with the narrative from VEXT's MD&A, which essentially suggests that cultivators geared up and over planted in anticipation of the state's recreational transition, and that is certainly an input that will likely continue to correct itself. However, to revisit a point we have raised above (and before), we also continue to believe that several of these states (and one may spill into the other), have a black-market problem that is impacting supply/demand equilibrium (ie: causing lower prices), which is particularly problematic for legal market players saddled with regulatory and tax burdens that place them at comparative disadvantages to their illegal competitors. In our view, reading between the lines, the reference above regarding "*revenue decline resulting from deep-seated issues with the state's legal weed market*", is likely an acknowledgment of the impact of the black market. Again, in our opinion, if these states intend to continue reaping the benefits of legals cannabis markets, they are going to have to loosen the grip of illegal participants from the throats of their golden geese. We view that element as a likely (albeit non-discriminate) ongoing structural headwind for VEXT and other legal players in Arizona and the surrounding region.

The above ugly truth noted, we again concur with VEXT's management that there are clear macroeconomic headwinds that have impacted the industry, which in turn is proving to be less resilient to some of those realities than many industry experts have historically imagined. Recall, (setting aside the flash recession of Q1F22 and Q2F22) the United States has not had a recession since Washington and Colorado became the first two states to legalize recreational marijuana in 2012. Clearly, the industry's defensive moniker is showing some cracks. As a result, we expect the coming quarters to provide continued challenges for the industry and most specifically to VEXT, the industry *in Arizona*. We will continue to handicap our models in that regard. However, we also think the addition and timing of Ohio may provide a welcome counter as its new/emerging and medical only protections should provide cover for licensed and especially integrated players. In addition, we will reiterate one of the cornerstones of our thesis, which we think despite the challenges of the quarter was once again borne out in the (relative) numbers. That is, we continue to believe that despite a stock price and market cap that might imply otherwise, management remains diligent, resilient and dialed in here, and we think that remains a good mix to weather the storm.

We reiterate our allocation of 7 and our 12-24 month price target of US$1.35.

# Projected Operating Model

| Vext Science, Inc. | | | | | | |
|---|---|---|---|---|---|---|
| **Projected Operating Model** | | | | | | |
| **By: Trickle Research LLC** | | | | | | |
| | (actual) | (estimate) | (estimate) | (estimate) | (estimate) | (estimate) |
| | 3/31/2023 | 6/30/2023 | 9/30/2023 | 12/31/2023 | Fiscal 2023 | Fiscal 2024 |
| Sales | $ 9,110,651 | $ 9,294,719 | $ 13,418,048 | $ 14,238,096 | $ 46,061,514 | $ 70,309,093 |
| Cost of Goods | $ 4,468,558 | $ 4,238,159 | $ 5,603,184 | $ 5,837,084 | $ 20,146,986 | $ 28,786,397 |
| Gross Profit Before Fair Value Adjustments | $ 4,642,093 | $ 5,056,559 | $ 7,814,864 | $ 8,401,012 | $ 25,914,528 | $ 41,522,696 |
| Unrealized Change in Fair Value of Biological Assets | $ (1,063,916) | $ - | $ - | $ - | $ (1,063,916) | $ - |
| Realized Change in Fair Value of Inventory Sold | $ 1,004,293 | $ - | $ - | $ - | $ 1,004,293 | $ - |
| Gross Profit | $ 4,701,716 | $ 5,056,559 | $ 7,814,864 | $ 8,401,012 | $ 25,974,151 | $ 41,522,696 |
| Operating Expenses: | | | | | | |
| Accretion | $ - | $ - | $ - | $ - | $ - | $ - |
| Amortization | $ 981,070 | $ 983,457 | $ 979,753 | $ 976,066 | $ 3,920,347 | $ 3,867,770 |
| Depreciation | $ 108,034 | $ 125,340 | $ 124,714 | $ 124,090 | $ 482,178 | $ 490,187 |
| Interest | $ - | $ - | $ - | $ - | $ - | $ - |
| Share Based Compensation | $ 130,332 | $ 130,332 | $ 130,332 | $ 130,332 | $ 521,328 | $ 486,394 |
| Salaries, Wages and Commissions | $ 1,617,844 | $ 1,637,304 | $ 2,239,122 | $ 2,355,482 | $ 7,849,751 | $ 11,594,142 |
| General and Administrative Expense | $ 1,050,538 | $ 1,078,842 | $ 1,202,541 | $ 1,227,143 | $ 4,559,064 | $ 5,309,273 |
| Other | $ - | $ - | $ - | $ - | $ - | $ - |
| Total Operating Expense | $ 3,887,818 | $ 3,955,275 | $ 4,676,462 | $ 4,813,113 | $ 17,332,668 | $ 21,747,766 |
| Other Expenses /Gains: | | | | | | |
| Share of Profit/Loss of Joint Ventures | $ 91,205 | $ (50,000) | $ (50,000) | $ (50,000) | $ (58,795) | $ (200,000) |
| Foreign Exchange (Gain) Loss | $ 2,726 | $ - | $ - | $ - | $ 2,726 | $ - |
| Interest (Income) Expense | $ 860,979 | $ 1,199,361 | $ 1,197,270 | $ 1,191,653 | $ 4,449,263 | $ 4,596,110 |
| Other | $ 926,994 | $ - | $ - | $ - | $ 926,994 | $ - |
| Total Other Expenses | $ 1,881,904 | $ 1,149,361 | $ 1,147,270 | $ 1,141,653 | $ 5,320,188 | $ 4,396,110 |
| Net Income Before Taxes | $ (1,068,006) | $ (48,077) | $ 1,991,132 | $ 2,446,245 | $ 3,321,295 | $ 15,378,820 |
| Income Tax Expense | $ 1,141,064 | $ (13,462) | $ 557,517 | $ 684,949 | $ 2,370,068 | $ 4,306,070 |
| Net Income After Taxes | $ 73,058 | $ (34,615) | $ 1,433,615 | $ 1,761,297 | $ 3,233,355 | $ 11,072,750 |
| Unrealized Gain (Loss) on Foreign Exchange Translation | $ - | $ - | $ - | $ - | $ - | $ - |
| Total Comprehensive Income | $ 164,263 | $ (84,615) | $ 1,383,615 | $ 1,711,297 | $ 3,174,560 | $ 10,872,750 |
| Basic Earnings per Common Share | $ 0.00 | $ (0.00) | $ 0.01 | $ 0.01 | $ 0.02 | $ 0.07 |
| Diluted Earnings per Common Share | $ 0.00 | $ (0.00) | $ 0.01 | $ 0.01 | $ 0.02 | $ 0.07 |
| Weighted Average Common Shares Outstanding | 149,514,914 | 149,514,914 | 149,514,914 | 149,514,914 | 149,514,914 | 149,514,914 |
| Weighted Average Diluted Shares Outstanding | 149,744,008 | 149,936,793 | 151,131,686 | 154,455,052 | 151,316,885 | 160,555,347 |

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**Rating System Overview:**

There are no letters in the rating system (Buy, Sell Hold), only numbers. The numbers range from 1 to 10, with 1 representing 1 "investment unit" (for my performance purposes, 1 "investment unit" equals $250) and 10 representing 10 investment units or $2,500. Obviously, a rating of 10 would suggest that I favor the stock (at respective/current levels) more than a stock with a rating of 1. As a guideline, here is a suggestion on how to use the allocation system.

Our belief at Trickle is that the best way to participate in the micro-cap/small cap space is by employing a diversified strategy. In simple terms, that means you are generally best off owning a number of issues rather than just two or three. To that point, our goal is to have at least 20 companies under coverage at any point in time, so let's use that as a guideline. Hypothetically, if you think you would like to commit $25,000 to buying micro-cap stocks, that would assume an investment of $1000 per stock (using the diversification approach we just mentioned, and the 20-stock coverage list we suggested and leaving some room to add to positions around allocation upgrades. We generally start initial coverage stocks with an allocation of 4. Thus, at $1000 invested per stock and a typical starting allocation of 4, your "investment unit" would be the same $250 we used in the example above. Thus, if we initiate a stock at a 4, you might consider putting $1000 into the position ($250 * 4). If we later raise the allocation to 6, you might consider adding two additional units or $500 to the position. If we then reduce the allocation from 6 to 4 you might consider selling whatever number of shares you purchased with 2 of the original 4 investment units. Again, this is just a suggestion as to how you might be able to use the allocation system to manage your portfolio.

**For those attached to more traditional rating systems (Buy, Sell, Hold) we would submit the following guidelines.**

**A Trickle rating of 1 thru 3 would best correspond to a "Speculative Buy" although we would caution that a rating in that range should not assume that the stock is necessarily riskier than a stock with a higher rating. It may carry a lower rating because the stock is trading closer to a price target we are unwilling to raise at that point. This by the way applies to all of our ratings.**

**A Trickle rating of 4 thru 6 might best (although not perfectly) correspond to a standard "Buy" rating.**

**A Trickle rating of 7 thru 10 would best correspond to a "Strong Buy" however, ratings at the higher end of that range would indicate something that we deem as quite extraordinary..... an "Extreme Buy" if you will. You will not see a lot of these.**