Grown Rogue (Canada: GRIN, OTC: GRUSF)

Warning: The following report is about a microcap company. Microcaps by definition can be illiquid and experience wild gyrations. It is important to do your own due diligence, rely on your own research and understand that microcaps can be very volatile. Please proceed reading using your highest levels of caution.

Introduction

Imagine an opportunity to invest in a mythical $100 billion market on its way to $200 billion in which capital is scarce, institutional participation is tiny and where many publicly traded companies involved are not listed in any major index or traded on any major US exchange.

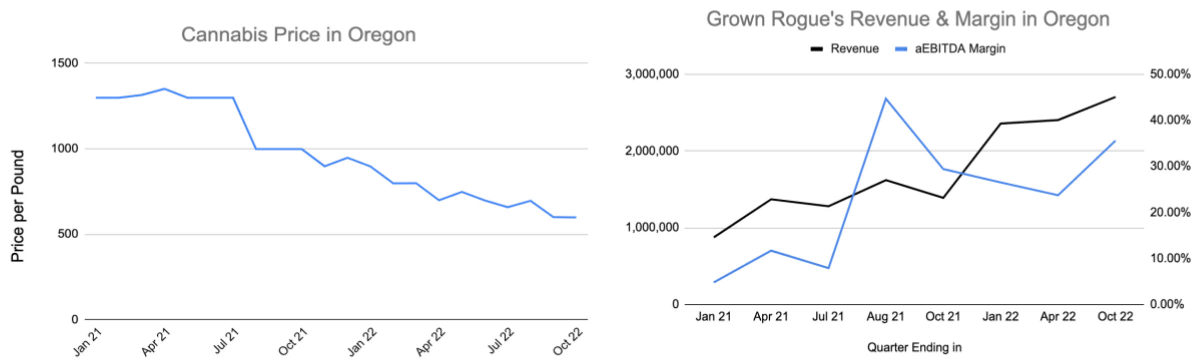
Prevailing wisdom is that to invest in cannabis, one needs to primarily focus on the larger cannabis companies, which are often referred to as Multi-State Operators (MSOs) which primarily operate in limited license markets that earn outsized margins in less competitive markets. Since capital is scarce, it is size that matters and especially size in markets with limited competition.

But my research tells me it is not licenses that are in limited supply, but operational excellence. Cannabis, while easy to grow in theory, is not very easy to grow at scale. And it is even harder to grow high-quality cannabis consistently at scale at a cost that is low enough to compete in unlimited license markets and with the illicit market. And no state shows this more than Oregon.

Oregon is not a limited license market and has the ideal environment for growing cannabis outdoors. The result is a major oversupply of cannabis and flower prices plunging to levels where it seems impossible to make a profit. Bottom line: if the product isn't high quality and low-priced, it's not going to sell, and even if it does sell, you're likely not going to make any money from it. Then you have the other challenges of operating in cannabis- limited capital access, the punitive 280E tax, and so on.

None of the largest cannabis players in the sector have any significant presence in Oregon due to this reality. Existing cultivators are closing shop by the dozens, and farms are going fallow. Yet amidst this bloodbath, one company has grown revenue by over 70% annually while improving EBITDA margins & generating the most elusive thing in cannabis: Free Cash Flow.

The company is Grown Rogue (Canada: GRIN, OTC: GRUSF), one of Oregon's leading brands.



Grown Rogue’s Revenue & Margins have improved even as cannabis pricing has crashed in Oregon. (Revenue numbers taken from company’s SEDAR filings while cannabis prices taken from OLCC)

One may be tempted to ask: is Oregon a fluke? Surely Grown Rogue couldn’t duplicate that in another competitive state, right?

And yet the company has done just that in Michigan after entering two years ago. Remember, Michigan has seen cannabis prices plunge from $3500 to $1000-$1500. Operators are howling about the terrible conditions in the state, and a large multi-state operator recently took a $331+ million write-down on an acquisition after just one year. In the meantime, Grown Rogue has risen to a top 5 flower market share position (according to Leaflink) and has reported positive Free Cash Flow from its operations in the state.

I think that something special is going on. Grown Rogue’s focused strategy on craft cultivation and relentless attention to costs and efficiency are enabling it to outperform everyone. If it can do this with prices at $1000 a pound (Michigan) and $800 a pound (Oregon), what happens when it enters a limited license state where prices are 2x-3x higher?

Grown Rogue’s Assets

Grown Rogue is headquartered in Medford, Oregon. It owns two outdoor cannabis farms in the state with a combined 80k square feet of canopy which covers a tiny fraction of the 80 acres the company owns, allowing them to expand production when needed with little capex. These farms are located in the famous emerald triangle region in south Oregon/North California, which contains the ideal climate for growing cannabis. This makes it a call option on interstate commerce, something which we shall cover later in the report.

However, Grown Rogue’s real value currently lies in its indoor capabilities. In Oregon, it owns two indoor facilities for a combined total of 47k square feet, with another 80k square feet in Michigan (50k of which is operational).

Most excitingly, the company is actively pursuing opportunities in several limited license states. More on that later.

Grown Rogue's Competitive Advantage

Grown Rogue approaches cannabis cultivation from a craft perspective. They start small and ensure the best practices are used, the yields are right, and the best, trendiest genetics are grown, and most importantly, that they are close to what customers want. It is only then that Grown Rogue expands. This is in stark contrast to just opening a big facility and blasting out cannabis, leading to cannabis of inconsistent quality produced at a high cost- a problem plenty of well-known large cannabis companies are struggling with.

But equally important to producing a great product is the cost of production. And here is where I believe the magic happens. Grown Rogue can produce high-quality indoor cannabis for an all-in cost of below $560 a pound (opex + COGS). This is why Grown Rogue is able to produce free cash flow in Oregon at an average selling price of $700-$800. And while headlines are filled with distress in Michigan cannabis as pricing crashes to $1000 a pound, that price is even more lucrative for Grown Rogue than Oregon.

Grown Rogue stands out for their relentless focus on cost and efficiency. The company has a low employee count per grow facility and a very lean management structure with a no-frills approach. CEO Obie Strickler sets an example by having in my opinion the worst CEO office I've ever seen. It is even generous to call it an office as it is a room off their main grow facility in Oregon and it has no doors. Obie jokes that the success comes from his "open door" policy! This frugality extends to capital expenditures as well. Grown Rogue has spent just $3.5 million of CapEx to build a top 5 flower producer in Michigan that generates Free Cash Flow and should earn over $8 million in annual revenue in 2022 and nearly $12 million in revenue in 2023. They have also eschewed fancy conferences and outside investor relations firms to keep G&A expenses low.

This focus on costs, capital, and culture might have something to do with the high insider ownership. Obie Strickler owns 20% of the company and insiders in total own over 40%. Keeping costs low certainly doesn't come at the expense of employee satisfaction. While visiting Grown Rogue in Oregon, I was struck by the smiles, passion, and general good feeling from every person I met. That includes everyone from trimmers, to grow technicians, their head of sales and cultivation director. This might well be their secret ingredient: motivated and passionate employees. This is a credit to Obie and the Grown Rogue management who consistently spoke about the importance of culture.

The most exciting part of all this: is that after witnessing what Grown Rogue is doing in Michigan, we now know that is entirely replicable across new markets.

2023 Projections

Grown Rogue has just completed an expansion of its indoor facility in Michigan, which will yield a 50% increase in cultivation. I also expect an average of 50%+ growth in its packaged flower offerings (included in indoor below), and Oregon outdoor farm. Conservatively assuming a 20% decline in Michigan indoor and flat pricing in Oregon, I expect Grown Rogue to do $21.7M in revenue in 2023. More importantly, I expect the company to show off its operating leverage, improving Gross Margin and keeping Opex constant to generate $6.5M in Adj. EBITDA at a 30% Adj. EBITDA Margin.

	FY 22	**FY 23**
Indoor Pounds Sold	17,799	21,400
Indoor ASP	864	850
Indoor Revenue	15,372	18,190
Outdoor Pounds Sold	2,551	5,600
Outdoor ASP	268	268
Outdoor Revenue	684	1,501
Pre-Roll Pounds Sold	178	300
Pre-Rolls ASP	1,779	1,400
Pre-Rolls Revenue	317	420
Trim and other Revenue	1352	1600
Total Revenue	**17,725**	**21,711**
COGS	8163	9655
Gross Profit	9,562	12,056
Gross Profit	54%	56%
Operating Expenses	5,525	5,600
Adj. EBITDA	**4,037**	**6,456**
Adj. EBITDA Margin	**22.78%**	**29.74%**

A key variable for Cannabis companies is the price of Cannabis in the future, where an analysis of licensing/harvest data provided by regulators can provide an indication of where we might be headed. Here, Oregon is showing very promising data. As you can see below, in 2022, indoor production had a sizable y-o-y decline due to low prices and cultivators reducing operations or letting operations go fallow. To date, indoor production from May 2022 to Nov 2022 is approximately 10% lower than the corresponding period last year.

Mixed Light and Outdoor harvest data is even more promising. The harvest this year is down 18% and 17% respectively.

	2020	**2021**	**2022**	**2022 versus 2021**
Mixed Light Production	1,785,009	1,928,348	1,584,793	-17.8%
Outdoor Production	4,123,323	6,383,142	5,310,250	-16.8%

Thus, 2023 should see modest pricing increases in Oregon. The latest Cannabis benchmark report already indicated that pricing in December was 5% higher than in November, unheard of so soon after ‘Croptober’! Note that nearly all of the increase flows straight down to the bottom line.

Even Michigan is showing a few green shoots. Detroit, by far the state’s largest city and a cannabis desert today in the legal market, just issued the first set of its 133 licenses. Once fully operational, this should expand the state’s market by at least 10%. The industry is also optimistic that its new top regulator will be much tougher on the strong illicit market in this state. This should reduce the demand-supply imbalance and offset some of the pricing weakness.

Now, I realize that $6.5 million may not sound like a lot. But what is more important is that Grown Rogue has figured out a formula that can be replicated and that formula can generate a lot more than $7 million.

What Happens When Grown Rogue Enters a Limited License Market?

After succeeding in the hyper-competitive markets of Oregon and Michigan, Grown Rogue is now looking east. So, what happens when a company with the ability to grow cannabis at an all-in price of $560 enters a market with average selling prices ranging as prices as high as $4000 a pound? The Michigan experience tells us that the company will take market share, generate cash, and grow profitably at much better margins due to higher prices. It means that markets like Massachusetts, now described as unattractive by MSOs as they lose market share and margins, are a potential gold mine for Grown Rogue.

The financial opportunity could not be greater. I estimate that even with a 20+% increase in their current cost structure for conservatism (all in cost of $700 instead of $560), Grown Rogue could earn at least $4 million in EBITDA from entering a new limited license state on limited capex like what it did in Michigan. Depending upon the production and average selling price in the state, it could be much higher.

		AVERAGE SELLING PRICE Per Pound					
		$1,500.00	**$2,000.00**	**$2,500.00**	**$3,000.00**	**$3,500.00**	**$4,000.00**
Annual Production	**5000 lbs**	$4.0m	$6.5m	$9.0m	$11.5m	$14.0m	$16.5m
	10000 lbs	$8.0m	$13.0m	$18.0m	$23.0m	$28.0m	$33.0m
	15000 lbs	$12.0m	$19.5m	$27.0m	$34.5m	$42.0m	$49.5m
	20000 lbs	$16.0m	$26.0m	$36.0m	$46.0m	$56.0m	$66.0m

If Grown Rogue can just enter one additional state next year, then the company could earn over $10.5 million in total, meaning the stock trades at just two times that number. Compare $6.5 million to $10.5 million in EBITDA today to Grown Rogue’s market cap of only slightly more than $20 million.

But one market is not the company’s end objective. According to the CEO, the company’s goal is to enter at least ten states in the next five years. That’s at least $40 million of additional potential cash flow. Do the math and you start to see the enormous upside that can occur to this small company as it enters limited license markets with its unbeatable cost structure, winning quality, and great prices. Grown Rogue doesn't have to be the biggest company to provide truly outsized returns to investors.

Interstate Commerce Opportunity

As mentioned above, Grown Rogue also operates a large outdoor farm in the Emerald Valley of Oregon, one of the country's largest cannabis producing regions with near-perfect growing conditions. This means Grown Rogue is an interstate commerce play as well. If need be, the company has plenty of potential to rapidly expand its outdoor grow and produce up to 80,000 lbs annually and to sell its indoor flower at much higher prices elsewhere. Consider that in New Jersey, flower is retailing for upwards of $8000 a pound, more than ten times the current price Grown Rogue is seeing for its product that is simply much, much better in quality.

Operational Excellence is in Short Supply in Cannabis, Licenses Are Not

Grown Rogue is interesting not only because of its potential to enter limited license states, but as an operational partner or even an acquisition target. I can think of several larger companies that have great licenses but struggle operationally. There are some interesting pairings, where 1+1 could equal much more than 3.

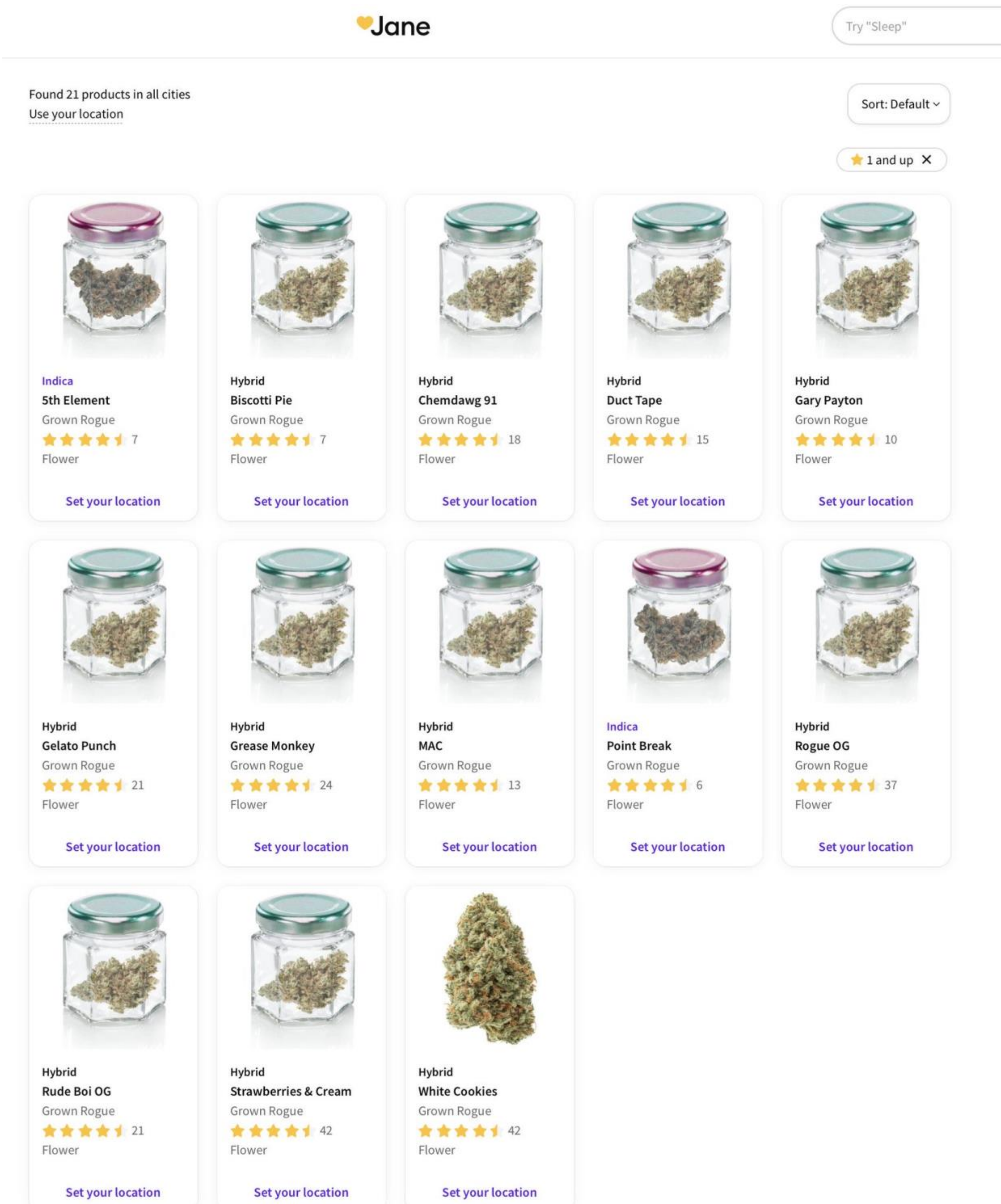
Summary

Grown Rogue is a craft indoor producer that also has outdoor capabilities as well. It's a hybrid play. Grown Rogue isn't trying to be Budweiser, but your local craft brand that everyone loves.

Grown Rogue may look small and insignificant, but my research tells me that what they are doing is special and can and should lead to outsized returns for investors. Investors who have been focused on limited licenses are missing out on the fact that operational excellence is what is in short supply in cannabis. The cannabis supply chain continues to be quite immature. There is a lack of consistent, high-quality cannabis grown at a great price for consumers. Grown Rogue has figured out the magic formula and now they are coming for those limited license states. And investors and competitors should pay attention.

There is a great interview with the CEO that you can find here:
https://open.spotify.com/episode/4GjXOOD7Xm7ADuVkXLJcvl

Here are some reviews from Jane of its products in Oregon:



Catalysts

1. Federal Reform such as SAFE Banking or De-Scheduling
2. Entry into new markets

3. Acquisitions or Joint Ventures

	Oregon Indoor	Michigan Indoor	Oregon Outdoor
Capex	$5M	$3M	$1M
Canopy Size	47k square feet	50k Square feet	80k Sq. feet
Total Size	47k Square feet	80k Square feet	80 Acres