

Equity Research: Cannabis

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EQUIPMENT FINANCING SOLUTIONS FOR CANNABIS COMPANIES

Xtraction Services addresses the capital constraint issue that the cannabis industry faces by providing equipment financing to cannabis companies. Particularly in a weak capital markets environment, many companies face difficulty accessing traditional banking services due to cannabis classification as a Schedule I substance. As well, the ability to raise significant capital has diminished and companies may not want to dilute shareholder bases and would prefer to generate cash flow instead. XS provides cannabis and hemp companies a ramp over this hurdle. As raising capital in the industry is challenging due to industry headwinds, we believe that Xtraction Services will become a key partner for companies facing capital constraints, which will enable them to build and grow businesses.

Leasing of extraction and related equipment allows businesses to make affordable payments over time instead of outlaying an initial large capital outlay. For companies that already own equipment, XS provides a sale-leaseback option, where these companies can sell equipment to XS, who will then lease it back. This can be perceived almost like a loan to XS's clients, where these companies will receive a lump-sum payment for their equipment then make lease payments on that equipment. The added benefit for cannabis companies is that unlike a loan, lease payments can be deducted from a company's income, whereas interest expenses cannot.

Equipment is costly and can be quite complicated. The extraction process is complicated, confusing, and requires expertise to optimize the process. Depending on the size of the operation, equipment can be a significant capital outlay, which reduces working capital for other productive business uses. New extraction methods and technological developments are constantly impacting the market, making it onerous to keep up. XS's leasing and sale-leaseback options help negate these obstacles by providing affordable lease payments and consulting services to assist clients in meeting the inherent challenges in setting up and maintaining such equipment. Xtraction Services also continuously updates its list of preferred vendors to ensure clients have access to quality equipment to optimize business needs.

FINANCIAL ANALYSIS

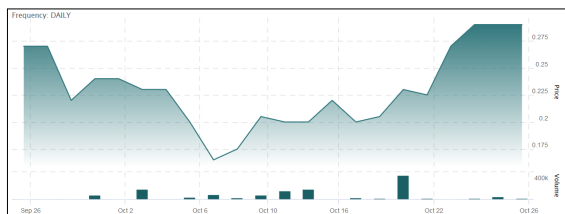
Promising pipeline of new customers. XS has signed 4 leasing agreements (including 2 royalty facilities). As of Q3/19, the Company is in discussion with 12 potential customers and is in the process of determining the best fit, which is based on a number of criteria, including size, duration and pricing options of the lease terms. Additionally, the Company has 1,200 active CRM leads for potential new clients. Currently, the average size of a financing is within the range of \$500K to \$1M but part of XS' growth strategy is to increase the size of financing to the \$1M-\$3M range.

VALUATION

Trades at a discount to peers. Based on the conservative assumption of 8 full-year customers in 2020 and 16 full-year customers by 2021E, at yearly revenue of \$500K per customer, XS trades at ~1.4x 2020E and ~0.7x 2021E EV/sales multiples, a sharp discount to junior peers, which trade at an average multiples of 4.3x and 3.6x, respectively.

XTRACTION SERVICES HOLDINGS CORP. CSE:XS	
<i>(Currency is CAD\$, unless noted otherwise)</i>	
<i>(Fiscal year-end is as of Dec. 31)</i>	
Last Price	\$0.29
52 Week Low / High	\$0.17 / \$0.80
Average Daily Volume (30-Day)	55K
CAPITALIZATION	
	Basic Diluted
Shares Outstanding (M)	29.1 72.3
Market Capitalization Basic (\$M)	\$8.4
Market Capitalization Fully Diluted (\$M)	\$21.0
Enterprise Value (\$M)	\$5.6
Cash (\$M)	\$6.6
Debt Balance (\$M)	\$3.8
RELATIVE VALUATION	
	EV/Sales
	2019E 2020E 2021E
Xtraction Services	5.6x 1.4x 0.7x
Regional Management	3.0x 2.7x 2.4x
Titan Machinery	0.7x 0.7x 0.7x
CAI International	6.0x 6.0x 5.6x
Herc Holdings	1.9x 1.8x 1.7x
GATX Corporation	5.7x 5.7x 5.6x
Fortress Transportation & Infrastructure	5.1x 3.8x n/a
General Finance Corporation	1.9x 1.9x 1.9x
Nesco Holdings	3.8x 3.3x 2.8x
Innovative Industrial Properties	23.2x 12.4x 8.3x
Mean	5.7x 4.3x 3.6x
Median	3.8x 3.3x 2.6x
MAJOR SHAREHOLDERS	
<i>Management and Insiders (38%)</i>	
DISCLOSURE CODE:	
Disclosure: None (See back page for further details)	

Source: Ubika, Capital IQ

Xtraction Services 1-Month Performance


Source: www.tmxmoney.com

COMPANY DESCRIPTION

Focused on the U.S. extraction equipment market, Xtraction Services (XS) provides equipment leasing solutions to owner/operators of cannabis and hemp companies, including cultivators, oil processors, manufacturers, and testing laboratories, among others. Xtraction Services provides flexible leasing options to assist cannabis companies in accessing equipment without the of raising equity at depressed prices to purchase equipment. The Company offers both leasing and sale-leaseback options that can be arranged to suit the needs of its clients.

BUSINESS MODEL

Xtraction Services has three main revenue streams:

Leasing

In XS's leasing model, XS will purchase the equipment itself and then lease the equipment to clients, targeting a return in excess of 50% gross IRR. Clients are required to put a down payment (such as 20-40%) on the equipment and will pay monthly lease payments on the financed amount, plus a factor rate and origination fees, to XS over a three-year term. Xtraction Services also provides consulting services to help guide clients on effective usage of the equipment, providing the Company with additional revenue streams.

Sale-Leaseback

In XS's sale-leaseback model, the client originally owns the equipment. Xtraction Services purchases the equipment at a depreciated value and then leases the equipment back to the client for an origination fee and monthly lease payments. This model allows the client to continue using the equipment with no interruption to operations, and frees up capital for the client. At the end of the three-year term, XS has the option to re-sell the equipment back to the customer at maturity. Xtraction Services anticipates it can generate a greater than 50% IRR on this type of transaction.

Royalty

Finally, in certain cases, XS also receives royalty payments from revenues that clients generate using the equipment. The royalty is based on the quantity of extracted products, allowing XS to benefit from additional upside of what is produced by clients.

EXTRACTION MARKET ANALYSIS

According to BDS Analytics, concentrate and vape sales are expected to reach \$8.4B and \$6.5B by 2022. Concentrates and vapes are expected to outpace the growth of the market for dried flower, which can be seen in mature markets. In Colorado, concentrate products went from 26% of total sales in 2015 to 38% of total sales in 2017. Additionally, data from the Washington Cannabis Board shows that ~18,000 kg of extracts were produced in 2017, a 353% increase from 5,100 kg in 2015. In Canada, medical flower sales slipped 28% to 1,697 kg in May 2019 (was 2,354 kg in April 2018). Meanwhile, sales of medical concentrates rose 52% to 5,688 kg (was 3,734 kg in April 2018).

Note on vaping epidemic. Cannabis companies have been under pressure recently. For example, the Horizons Marijuana Life Sciences Index (HMMJ) is down ~50% from its 2019 high. One of the reasons for this weakness could be attributed to the vaping epidemic, with the Center for Disease Control (CDC) reporting 1000 cases and 18 deaths related to vaping. The illness seems to have been caused by illegal thickening agents, such as Vitamin E acetate, which is reported to become carcinogenic when heated in a vape. Some municipalities and states in the U.S. have considered banning vape products in reaction, which has caused concern over future vape sales. The total impact remains to be seen, however, this could be a positive for regulated vape producers, such as XS, that sell extraction equipment to legal cannabis companies that use pharmaceutical-grade quality and safety standards.

Passing of the SAFE Banking Act by the House was an important step forward. On September 25, 2019, the U.S. House of Representatives passed the SAFE Banking Act, with 70%+ of its members voting to pass the bill. While the SAFE Banking Act still has some challenges, such as being passed by the Senate, we view the passage of the SAFE Banking Act as overall positive for XS. Of note, the SAFE Banking Act allows cannabis companies operating in federal legal states to access banking services, such as chequing accounts, interact and credit card terminals. Since U.S. commercial banks have been getting out of the business of lending to small and medium sized enterprises, the SAFE Banking Act would make it easier for companies such as Xtraction Services to obtain credit from commercial banks that do not want to work with small to mid sized cultivators.

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Buy: Recommendation: stock is expected to appreciate from its current price beyond 20% in the next 12 months.

Neutral: Recommendation: stock is expected to trade in a narrow range from its current price level in the next 12 months.

Sell: Recommendation: stock is expected to decline from its current price level below 20% in the next 12 months.

U/R: Under Review.

N/R: Not Rated.

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