

Fundamental Research Corp.

Investment Analysis for Intelligent Investors

May 7, 2019

Lexaria Bioscience Corp. (CSE: LXX / OTCQX: LXRP) – Focus Seemingly on R&D as Licensing Revenues Slow to Take Off – FINAL REPORT

Sector/Industry: Cannabis

www.lexariabioscience.com

Market Data (as of May 7, 2019)

Current Price	US\$0.98
Fair Value	US\$2.35
Rating*	BUY
Risk*	4
52 Week Range	US\$0.81 - US\$2.35
Shares O/S	78,387,134
Market Cap	US\$76.82 mm
Current Yield	N/A
P/E (forward)	N/A
P/B	20.36x
YoY Return	-33.78%
YoY Russell 2000	1.80%

*see back of report for rating and risk definitions.

* All figures in US\$ unless otherwise specified.



Highlights

- Lexaria Bioscience Corp. (“company”, “Lexaria”) reported revenue of \$15k in Q2-FY2019 (quarter ended February 28, 2019), reflecting a YoY decline of 91.07%.
- **We are revising our FY2019 and FY2020 forecasts to \$83k (from \$0.49 million) and \$0.12 million (from \$1.88 million), respectively.**
- Net loss decreased in Q2-FY2019 to \$1.15 million (EPS: -\$0.01), versus Q2-FY2018’s net loss of \$1.38 million (EPS: -\$0.02).
- **We are revising our earnings forecasts to -\$4.14 million (EPS: -\$0.05) from -3.20 million (EPS: -\$0.04) for FY2019, and to -\$4.26 million (EPS: -\$0.05) from -\$1.75 million (EPS: -\$0.02) for FY2020.**
- With the company having previously entered into an R&D focused investment partnership with Altria Group Inc. (NYSE: MO), we believe that poor operating results may be indicative of the company’s pivot from focusing on revenue generation to focusing on R&D. Through this focus, the company may be able to attract attention from large entities to partner (as in the case of Altria) leading to large potential licensing revenue in the future.
- **We are revising our fair value estimate of \$3.50 per share to \$2.35 per share.**

Key Financial Data (FYE- Aug 31)

(US\$)	2017	2018	2019E	2020E
Revenue	\$ 63,639	\$ 433,287	\$ 82,628	\$ 123,941
Net Income	\$ -1,929,465	\$ -6,609,187	\$ -4,137,487	\$ -4,264,291
EPS	\$ -0.03	\$ -0.09	\$ -0.05	\$ -0.05
Cash	\$ 2,533,337	\$ 1,727,184	\$ 2,219,170	\$ 1,099,593
Working Capital	\$ 2,703,148	\$ 2,240,411	\$ 2,333,130	\$ 1,218,455
Debt	\$ -	\$ -	\$ -	\$ -
Total Assets	\$ 2,860,178	\$ 2,431,826	\$ 3,894,025	\$ 3,885,581
Shareholders' Equity	\$ 2,767,831	\$ 2,388,186	\$ 3,442,830	\$ 3,389,884

**Licensing
Revenues
Disappoint**

The company reported Q2-FY2019 revenues of \$15.35k, reflecting a YoY revenue decline of 91.07%. For the six months, revenue was \$37.56k in FY2019 versus \$0.20 million in FY2018, reflecting a YoY decline of 80.90%. The reason for the decline in revenues was undisclosed. **The company has six licensees, after accounting for two new licensees that were onboarded in April and May of 2019, and one that was terminated for non-performance.** Only one of the licensees is currently generating revenues. The slow growth of licensees is due to delays in cannabis edibles and other infused goods legislation within Canada, according to management. As the company's technology is based on drug delivery most applicable to edibles, the addressable market available domestically to the company prior to legalization of infused goods is smaller than it would otherwise be with legal edibles. The following tables outline the company's operating performance, as well as segmented revenues.

STATEMENTS OF OPERATIONS				
(in US\$) - YE Aug 31st	Q2-2018	Q2-2019	2018 (6M)	2019 (6M)
Revenue	171,958	15,349	196,593	37,558
COGS	13,713	2,690	19,812	4,848
Gross Profit	158,245	12,659	176,781	32,710
EXPENSES				
Operating Expenses	1,534,721	1,155,793	2,128,049	1,866,002
SG&A Expense	1,458,959	1,089,710	1,941,895	1,702,946
Share-based Compensation				
Research & Development	75,762	66,083	186,154	163,056
EBITDA	(1,376,476)	(1,143,134)	(1,951,268)	(1,833,292)
Depreciation	462	10,086	837	11,689
Amortization				
EBIT	(1,376,938)	(1,153,220)	(1,952,105)	(1,844,981)
Financing Costs				
EBT	(1,376,938)	(1,153,220)	(1,952,105)	(1,844,981)
Non-Recurring Expenses	1,440	-109	4,986	9,521
Taxes				
Net Profit (Loss)	(1,378,378)	(1,153,111)	(1,957,091)	(1,854,502)
Non-Controlling Interest		5,135		5,135
Net comprehensive Profit (Loss)	(1,378,378)	(1,147,976)	(1,957,091)	(1,849,367)
Shares outstanding	70,414,177	77,507,550	69,519,973	76,079,651
EPS	\$ -0.02	\$ -0.01	\$ -0.03	\$ -0.02

Source: FRC, Company Financial Statements

	Six Months Ended	
	February 28 2019	February 28 2018
	\$	\$
Product sales	5,436	11,709
Licensing revenue (Note 11)	32,000	184,083
Freight revenue	122	801
	37,558	196,593

Source: Company Financial Statements

Revenue Forecasts Revised

With the continuous underperformance relative to our revenue forecasts, and the minor pace of revenue generation from licensing, it would appear Lexaria’s revenue growth prospects are dimming. **We are revising our revenue forecasts to \$82.63k (from \$0.49 million) and \$0.12 million (from \$1.88 million) for FY2019 and FY2020, respectively.**

STATEMENTS OF OPERATIONS		
(in US\$) - YE Aug 31st	2019E	2020E
Revenue	82,628	123,941
COGS	10,666	15,998
Gross Profit	71,962	107,943
EXPENSES		
Operating Expenses	4,177,588	4,326,674
SG&A Expense	3,882,366	3,960,013
Share-based Compensation		12,394
Research & Development	295,222	354,266
EBITDA	(4,105,626)	(4,218,731)
Depreciation	31,861	42,709
Amortization		
EBIT	(4,137,487)	(4,261,440)
Financing Costs		
EBT	(4,137,487)	(4,261,440)
Non-Recurring Expenses		
Taxes		
Net Profit (Loss)	(4,137,487)	(4,261,440)
Non-Controlling Interest		
Net comprehensive Profit (Loss)	(4,137,487)	(4,261,440)
Shares outstanding	77,370,421	77,370,421
EPS	\$ -0.05	\$ -0.06

Source: FRC

Our long-term revenue forecasts have also been revised lower to reflect a slower licensing roll-out than previously expected. As mentioned before, Lexaria will need to either sign new license agreements, generate meaningful revenues through new product launches, and / or ramp up sales from existing licensees if it is to meet revenue forecasts.

Though our revenue forecasts have been continuously reduced over the term of our coverage of the company, we do speculate that the lack of revenue growth may be attributable to a focus on R&D. With Altria Inc.’s investment (which we covered in our previous update), Lexaria has an incentive to forego near-term revenues, and instead focus on testing of DehydraTECH™ for its applications to nicotine. Because future funding from Altria (and as we have speculated, a potential buy-out) is dependent on the company confirming that their drug delivery technology is effective for nicotine, the company may not be focusing on revenue generation to focus on this ulterior objective.

Margins	Q2-2018	Q2-2019	2018 (6M)	2019 (6M)
Gross	92.03%	82.47%	89.92%	87.09%
EBITDA	-800.47%	-7447.61%	-992.54%	-4881.23%
EBIT	-800.74%	-7513.32%	-992.97%	-4912.35%
Net	-801.58%	-7512.61%	-995.50%	-4937.70%

Source: FRC, Company Financial Statements

Gross margins decreased in Q2-FY2019 to 82.47%, compared to 92.03% in Q2-FY2018. EBITDA increased slightly to -\$1.14 million in Q2-FY2019, versus Q2-FY2018's -\$1.38 million. Furthermore, operating costs dropped 24.69% YoY (primarily because of lower consulting fees) to \$1.16 million in Q2-FY2019, compared to \$1.52 million in Q2-FY2018.

Net loss for Q2-FY2019 was \$1.15 million (EPS: -\$0.01), versus \$1.38 million (EPS: -\$0.02) for Q2-FY2018. **We are revising our earnings forecasts to -\$4.14 million (EPS: -\$0.05) from -3.20 million (EPS: -\$0.04) for FY2019 and -\$4.26 million (EPS: -\$0.05) from -\$1.75 million (EPS: -\$0.02) for FY2020.**

Lexaria's free cash flows ("FCF") were negative for the first six months of FY2019, despite positive inflows from investing activities (from Altria's investment).

Summary of Cash Flows (\$, mm)	2018 (6M)	2019 (6M)
Operating	-\$1.12	-\$1.17
Investing	-\$0.10	\$0.50
Financing	\$1.01	\$2.03
Effects of Exchange Rate	\$0.00	\$0.00
Net	-\$0.22	\$1.37
Free Cash Flows to Firm (FCF)	-\$1.22	-\$0.66

Source: FRC, Financial Statements

Cash Position and Working Capital Remain Strong

At the end of Q2-FY2019, the company had a cash position of \$3.09 million and working capital of \$3.14 million, as well as a current ratio of 7.28x. Furthermore, the company remains debt-free. The liquidity and solvency position of the company is likely to remain strong, given the backstop from Lexaria's investment agreement with Altria, details of which we outlined in our previous update.

(in US\$) - YE Aug 31st	
Liquidity & Capital Structure	Q2-2019
Cash	3,093,211
Working Capital	3,140,485
Current Ratio	7.28
LT Debt	-
Total Debt	-
LT Debt / Capital	-
Total Debt / Capital	-
Total Invested Capital	680,253

Source: FRC, Financial Statements

Valuation

Stock Options and Warrants: We estimate that the company has 4.73 million stock options (weighted average exercise price of \$0.85) and 2.94 million warrants (weighted average exercise price of \$1.32) outstanding. 2.05 million options and 0.46 million warrants are currently in-the-money. The company has the potential to raise up to \$0.84 million if all the in-the-money options and warrants are exercised.

We are maintaining our BUY rating on the company, and revising our fair value estimate on Lexaria’s shares to \$2.35 per share from our previous fair value of \$3.50 per share. The significant drop in value is due to diminished revenue forecasts as well as forecasted shortfalls in cash during the near-term, resulting in significant increases in shares issued in our models.

Risks

We believe the company is exposed to the following risks (list is non-exhaustive):

- Possible inability to apply Lexaria’s delivery technology to any (or all) of the proposed market segments targeted will materially impact the company’s valuation.
- Lexaria’s existing patents do not guarantee international protection of their technology- further patents from relevant authorities will be needed to protect the company’s technology in other jurisdictions.
- The cannabis regulatory environment in North America exhibits high levels of uncertainty and is open to external interference beyond Lexaria’s control. Adverse political or regulatory changes may materially impact the Company’s valuation.
- The company has yet to exhibit a track record of profitability, despite operations generating revenue.
- Exchange rate risk.
- Access to capital and share dilution.

We are maintaining our risk rating of 4 (Speculative).

Appendix

STATEMENTS OF OPERATIONS				
(in US\$) - YE Aug 31st	2017	2018	2019E	2020E
Revenue	63,639	433,287	82,628	123,941
COGS	29,750	25,185	10,666	15,998
Gross Profit	33,889	408,102	71,962	107,943
EXPENSES				
Operating Expenses	1,958,225	7,006,014	4,177,588	4,329,650
SG&A Expense	1,904,040	6,513,150	3,690,234	3,764,039
Share-based Compensation			192,132	211,345
Research & Development	54,185	492,864	295,222	354,266
EBITDA	(1,924,336)	(6,597,912)	(4,105,626)	(4,221,707)
Depreciation	1,488	2,307	31,861	42,584
Amortization				
EBIT	(1,925,824)	(6,600,219)	(4,137,487)	(4,264,291)
Financing Costs	6,015			
EBT	(1,931,839)	(6,600,219)	(4,137,487)	(4,264,291)
Non-Recurring Expenses		8,968		
Taxes	-2,374			
Net Profit (Loss)	(1,929,465)	(6,609,187)	(4,137,487)	(4,264,291)
Non-Controlling Interest		10,344		
Net comprehensive Profit (Loss)	(1,929,465)	(6,598,843)	(4,137,487)	(4,264,291)
Shares outstanding	58,765,806	70,960,416	78,387,134	78,387,134
EPS	\$ -0.03	\$ -0.09	\$ -0.05	\$ -0.05

BALANCE SHEET				
(in US\$) - YE Aug 31st	2017	2018	2019E	2020E
ASSETS				
CURRENT				
Cash and Cash Equiv.	2,533,337	1,727,184	2,219,170	1,099,593
A/R	45,293	265,751	241,016	265,117
Inventory	67,174	87,233	118,820	130,702
Marketable Securities		10,151	71,127	71,127
Prepaid Expenses	149,691	193,732	134,193	147,612
Total Current Assets	2,795,495	2,284,051	2,784,325	1,714,151
Patent	62,827	146,538	258,024	391,807
Equipment	1,856	1,237	851,676	1,779,622
Total Assets	2,860,178	2,431,826	3,894,025	3,885,581
LIABILITIES				
CURRENT				
A/P	32,574	35,785	445,012	489,513
Unearned Revenue	17,083			
Due to Related Parties	42,690	7,855	6,183	6,183
Total Current Liabilities	92,347	43,640	451,195	495,697
Convertible Debt				
Total Liabilities	92,347	43,640	451,195	495,697
SHAREHOLDERS EQUITY				
Share Capital	67,976	75,533	78,002	78,002
Additional Paid-In Capital	16,108,270	22,095,682	27,285,344	31,496,689
Accumulated Deficit	- 13,169,939	- 19,768,782	- 23,920,516	- 28,184,807
Non-Controlling Interest	- 238,476			
AOCI	-	14,247		-
Total shareholders' equity (deficiency)	2,767,831	2,388,186	3,442,830	3,389,884
Total Liabilities and Shareholders Equity	2,860,178	2,431,826	3,894,025	3,885,581

STATEMENTS OF CASH FLOWS

(in US\$) - YE Dec 31st

	2017	2018	2019E	2020E
OPERATING ACTIVITIES				
Net Profit for the Year	- 1,929,465 -	6,609,187 -	4,137,487 -	4,264,291
Adjusted for items not involving cash:				
Discontinued Operations				
Stock-based Compensation	113,044	2,602,239	192,132	211,345
Depreciation and Amortization	1,488	2,307	31,861	42,584
Inventory Writeoff	68,611	12,966		
Unrealized FOREX		602		
Common Stock to be Issued for Services				
Common Stock Issued for Interest	1,125			
Common Stock Issued for Services	207,660	781,056		
Depletion				
Unrealized Loss on Marketable Securities				
Write off of Oil & Gas Property				
Warrants Issued for Services	292,750	1,063,270		
Research and Development				
Non-cash for Licensing				
MMJ JV				
Funds From Operations	- 1,244,787 -	2,146,747 -	3,913,494 -	4,010,362
Change in working capital				
A/R	- 7,710 -	245,458	24,736 -	24,102
Inventory	- 1,061 -	33,025 -	31,587 -	11,882
Prepaid Expenses and Deposit	- 17,817 -	44,041	59,539 -	13,419
A/P	- 40,436	3,210	409,227	44,501
Due to Related Parties	- 238,681 -	34,835 -	1,672	-
Unearned Revenue	4,583 -	17,083	-	-
NET CASH USED IN OPERATING ACTIVITIES	- 1,545,909 -	2,517,979 -	3,453,251 -	4,015,264
INVESTING ACTIVITIES				
Sale of Oil & Gas Property				
Oil & Gas Acquisition and Exploration Costs				
MMJ Investments		-	60,976	
Altria Investment			1,000,000	
Investment in Associate	-	70,000		
Patent	- 9,699 -	85,399 -	111,486 -	133,783
Acquisition of Equipment			882,300 -	970,530
NET CASH USED IN INVESTING ACTIVITIES	- 9,699 -	155,399 -	54,762 -	1,104,313
FINANCING ACTIVITIES				
Proceeds from Loans/ Convertible Debt	- 50,000			
Proceeds from Equity Issue	4,045,536	1,867,224	4,000,000	4,000,000
NET CASH FROM FINANCING ACTIVITIES	3,995,536	1,867,224	4,000,000	4,000,000
Foreign Exchange / Others				
INCREASE IN CASH FOR THE PERIOD	2,439,928 -	806,154	491,987 -	1,119,577
CASH, BEGINNING OF THE PERIOD	93,409	2,533,337	1,727,183	2,219,170
CASH, END OF THE PERIOD	2,533,337	1,727,183	2,219,170	1,099,593

Fundamental Research Corp. Equity Rating Scale:

Buy – Annual expected rate of return exceeds 12% or the expected return is commensurate with risk

Hold – Annual expected rate of return is between 5% and 12%

Sell – Annual expected rate of return is below 5% or the expected return is not commensurate with risk

Suspended or Rating N/A— Coverage and ratings suspended until more information can be obtained from the company regarding recent events.

Fundamental Research Corp. Risk Rating Scale:

1 (Low Risk) - The company operates in an industry where it has a strong position (for example a monopoly, high market share etc.) or operates in a regulated industry. The future outlook is stable or positive for the industry. The company generates positive free cash flow and has a history of profitability. The capital structure is conservative with little or no debt.

2 (Below Average Risk) - The company operates in an industry where the fundamentals and outlook are positive. The industry and company are relatively less sensitive to systematic risk than companies with a Risk Rating of 3. The company has a history of profitability and has demonstrated its ability to generate positive free cash flows (though current free cash flow may be negative due to capital investment). The company's capital structure is conservative with little to modest use of debt.

3 (Average Risk) - The company operates in an industry that has average sensitivity to systematic risk. The industry may be cyclical. Profits and cash flow are sensitive to economic factors although the company has demonstrated its ability to generate positive earnings and cash flow. Debt use is in line with industry averages, and coverage ratios are sufficient.

4 (Speculative) - The company has little or no history of generating earnings or cash flow. Debt use is higher. These companies may be in start-up mode or in a turnaround situation. These companies should be considered speculative.

5 (Highly Speculative) - The company has no history of generating earnings or cash flow. They may operate in a new industry with new, and unproven products. Products may be at the development stage, testing, or seeking regulatory approval. These companies may run into liquidity issues, and may rely on external funding. These stocks are considered highly speculative.

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