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Fundamental Research Corp.
Investment Analysis for Intelligent Investors

January 8, 2020

Eve & Co Inc. (TSXV: EVE / OTCQX: EEVVF) – Revenue Increase 102% QoQ / Facility Expansion Approved by Health Canada – FINAL REPORT

Sector/Industry: Cannabis

Click here for more research on the company and to share your views

Market Data (as of January 8, 2020)

Current Price	**$0.18**
Fair Value	**$0.54**
Rating*	**BUY**
Risk*	**4**
52 Week Range	$0.12- $0.63
Shares O/S	287,867,172
Market Cap	$51.82 million
Current Yield	N/A
P/E (forward)	N/A
P/B	1.54x
YoY Return	-50.68%
YoY TSXV	-0.93%

*see back of report for rating and risk definitions.
*all $ amounts are in C$ unless otherwise specified.

Highlights

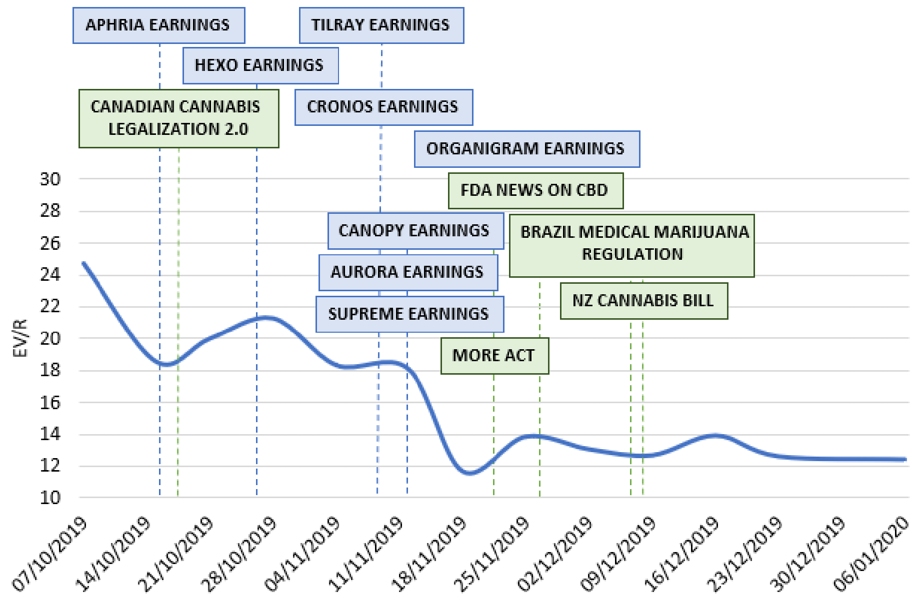
- Eve & Co Inc. ("Eve & Co", "company") reported Q3-2019 financials, with revenue growing 102% quarter-over-quarter ("QoQ"). The company shipped 242 kg of dried cannabis flower and trim at an average revenue per kg of $3,797 (a QoQ increase of 53%). **Given the current state of the Canadian cannabis market, and a delay in the commencement of its German supply contracts, we are revising our 2019, and 2020, revenue forecasts to $4.31 million (previously $7.25 million) and $47.88 million (previously $73.38 million), respectively.**
- The company's normalized gross margin for Q3-2019 was 20.84% compared to 38.61% in the preceding quarter. **The deterioration in gross margin, indicated by management, was due to lower high margin bulk sales.** We are revising our gross margin forecasts for 2019, and 2020, to 35.65% (previously 44.42%) and 42.59% (previously 58.73%), respectively.
- SG&A expenses for Q3-2019 were $0.83 million, a QoQ decrease of 23%. The decline was primarily due to lower professional fees and consulting and contract work. Our 2019, and 2020, SG&A expense forecasts seem to be too high and we are revising these to $3.37 million (previously $6.54 million) and $9.58 million (previously $14.68 million), respectively.
- The company reported a net loss of -$1.96 million (EPS: -$0.01) for Q3-2019, compared to net income of $0.36 million (EPS: $0.00) for Q2-2019. The deterioration in bottom line QoQ was primarily due to changes in the fair value of company biological assets. Our revised earnings forecast for 2019, and 2020, are -$4.36 million (EPS: -$0.02) and $6.88 million (EPS: $0.02), respectively. This compares to our previous earnings forecast for 2019, and 2020, of -$6.58 million (EPS: -$0.02) and $19.75 million (EPS: $0.07), respectively.
- The company's 0.78 million sq. ft. facility expansion was approved by Health Canada in December 2019. In addition, the company now has a distribution footprint to the provinces of Ontario, Saskatchewan, Manitoba and Newfoundland and Labrador.

Key Financial Data (FYE - DEC 31) (C$)	*YE OCT 31st 2017*	2018	2019E	2020E
Cash	$ 91,400	$ 1,038,174	$ 7,248,996	$ 12,166,417
Working Capital	$ -4,086,754	$ 3,901,877	$ 11,463,441	$ 19,539,755
Assets	$ 2,067,680	$ 23,488,377	$ 55,605,227	$ 65,165,743
Total Debt	$ 2,654,423	$ 4,322,099	$ 17,976,000	$ 17,976,000
Revenues	$ -	$ 482,663	$ 4,305,508	$ 47,875,000
Net Income	$ -1,241,034	$ -7,649,075	$ -4,362,266	$ 6,879,439
EPS (basic)	$ -0.01	$ -0.04	$ -0.02	$ 0.02

Update on the Canadian Cannabis Market

Plagued by early signs of pricing pressure, and the build-up of dried cannabis flower inventory, performance of the Canadian cannabis market has fallen significantly below investor expectations. Against the backdrop of poor earnings results by major Canadian Licensed Producers ("LPs"), **valuations that Canadian cannabis companies are trading at are near all-time lows.** The following shows the average Enterprise Value to Revenue ("EV/R") that cannabis companies are currently trading at. The change in average EV/R due to notable news are also presented below.

EV/R Multiples Valuation



Constituents: Aphria Inc., Aurora Cannabis Inc., Canopy Growth Corp., Cronos Group Inc., Tilray Inc., HEXO Corp, CannTrust Holdings Inc, Organigram Holdings Inc., The Supreme Cannabis Co., Inc.

Source: FRC, S&P Capital IQ

To illustrate pricing pressure, the following shows the QoQ change in selling price per gram of dried cannabis of major Canadian LPs. **Of the six major Canadian LPs below, four reported a decline in their selling price per gram.**

Illustration of Pricing Pressure

HEXO (NYSE: HEXO)	
FQ1-2020	$3.24
FQ4-2019	$3.51

Note: This table is the average adult-use net revenue per gram.
Source: HEXO MD&A

-8% QoQ

Cronos Group (TSX: CRON)	
Q3-2019	$3.75
Q2-2019	$6.44

Note: This table is the net product revenue per gram.
Source: Cronos Group MD&A

-42% QoQ

Tilray (NASDAQ: TLRY)	
Q3-2019	$3.25
Q2-2019	$4.61

Note: This table is the average net selling price per gram.
Source: Tilray MD&A

-30% QoQ

Aphria (TSX: APHA)	
FQ1-2020	$6.02
FQ4-2019	$5.73

Note: This table is the average selling price before excise taxes for the company's adult-use market.
Source: Aphria MD&A

+5% QoQ

Canopy Growth (TSX: WEED)	
FQ2-2020	$7.50
FQ1-2020	$7.56

Note: This table is the average selling price per gram (total).
Source: Canopy Growth MD&A

-1% QoQ

Aurora Cannabis (TSX: ACB)	
FQ1-2020	$5.28
FQ4-2019	$5.14

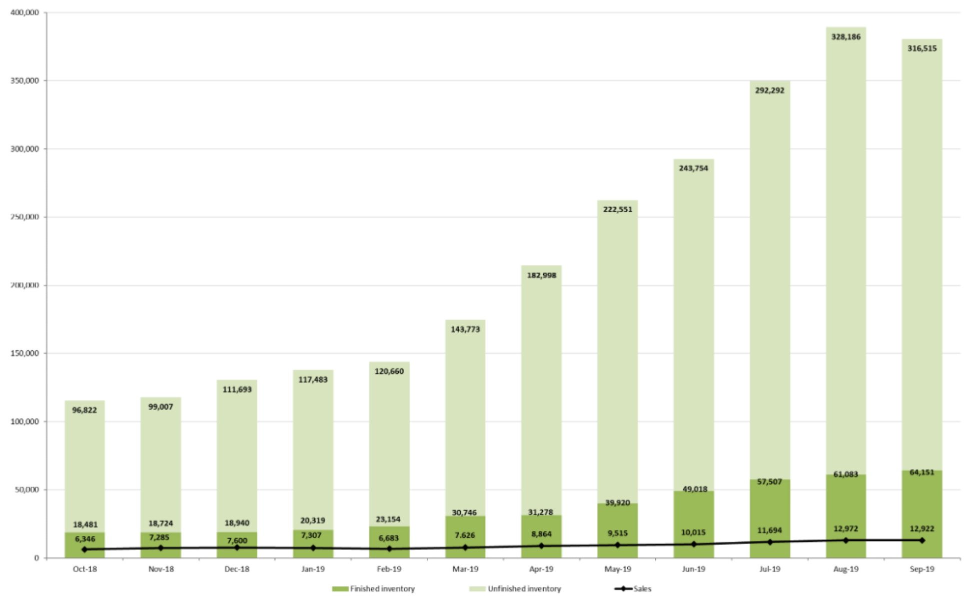
Note: This table is the average net selling price of consumer cannabis
Source: Aurora Cannabis MD&A

+3% QoQ

Source: FRC

To illustrate inventory build-up, the following shows the month-over-month ("MoM") growth in finished inventories and sales. **For the month of September 2019, finished inventories grew by 5.02% while sales declined by 0.4%.**

Illustration of Inventory Build-Up



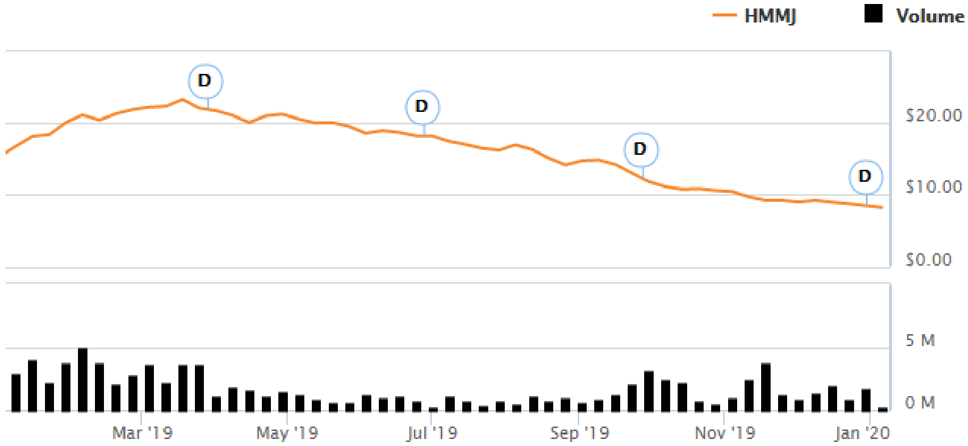
Month	Finished inventory	Unfinished inventory	Sales	FI Growth	Sales Growth
Oct-18	18,481	96,822	6,346	-	-
Nov-18	18,724	99,007	7,285	1.31%	14.8%
Dec-18	18,940	111,693	7,600	1.15%	4.3%
Jan-19	20,319	117,483	7,307	7.28%	-3.9%
Feb-19	23,154	120,660	6,683	13.95%	-8.5%
Mar-19	30,746	143,773	7,626	32.79%	14.1%
Apr-19	31,278	182,998	8,864	1.73%	16.2%
May-19	39,920	222,551	9,515	27.63%	7.3%
Jun-19	49,018	243,754	10,015	22.79%	5.3%
Jul-19	57,507	292,292	11,694	17.32%	16.8%
Aug-19	61,083	328,186	12,972	6.22%	10.9%
Sep-19	64,151	316,515	12,922	5.02%	-0.4%

October 2018 was used as the base month – finished inventories ("FI") growth and sales growth references a month-over-month comparison. Figures are in kg unless otherwise stated.

Source: Government of Canada, FRC

Lastly, to reflect poor market sentiment regarding cannabis companies, the following graph plots the performance of the Horizons Marijuana Life Sciences Index ETF (TSX: HMMJ / "HMMJ"). Over a one-year period, the HMMJ has declined 49% in value and is trading at its 52-week low of $8.10. **Citing contraction of the cannabis market, the HMMJ removed seven constituents from its portfolio, one of which was Eve & Co.** It was disclosed that these constituents were removed due to them falling below their minimum inclusion threshold.

One-Year Performance of the HMMJ



	1-Month	6-Months	1-Year
Performance	-13.26%	-54.59%	-48.83%

Source: https://www.horizonsetfs.com/hmmj, FRC

Given that Eve & Co is currently a dried cannabis flower supplier and not a cannabis products producer, readers should keep in mind that **pricing pressure and dried cannabis flower inventory build-up are pertinent issues faced by Eve & Co.** As the Canadian cannabis market moves towards commoditization, readers should expect the selling price per gram of dried cannabis flower to continually trend downwards.

With that said, we believe that Eve & Co is attempting to shift from being a commodity producer to become a cannabis consumer packaged goods ("CPG") producer. **On November 22, 2019, the company entered into an exclusive letter of intent ("LOI") with a leading winery in Canada ("Colio Estate Wines") to develop a cannabis-infused beverage for launch into the Canadian cannabis market.** Readers should note that Eve & Co currently holds a processing licence, which would allow for the manufacture of cannabis-derived products. With that said, we are not privy to any bottling or cannabis beverages manufacturing capabilities at the company's facility. Management has stated that if an agreement is executed, the business model is expected to follow a co-packer business model. A co-packer business model involves the company providing cannabis inputs to a third-party bottler for manufacture into cannabis beverages.

Next, we discuss notable company developments.

Company Developments

In our last update report on the company, we outlined the completion of the company's 0.78 million square feet ("sq. ft.") facility expansion, bringing the company's total greenhouse facility to one million sq. ft. On December 16, 2019, Health Canada approved the 0.78 million sq. ft. expansion to be used as a grow area. As such, **the company now has a total expected production capacity of 50,000 kg per annum.** We expect the company's new expansion area to contribute to dried cannabis flower cultivation starting Q1-2020**.**

In conjunction with this approval, the company is now approved to sell dried cannabis flower to the provinces of Ontario and Saskatchewan. We believe the company now has a distribution channel to four provinces: (1) Newfoundland and Labrador, (2) Manitoba, (3) Ontario, and (4) Saskatchewan.

Company Distribution Footprint

Company's distribution footprint is highlighted in blue.

Source: mapchart.net, FRC

Provinces where the company has a distribution channel in are expected to comprise 48% of Canada's adult-use cannabis market by 2024. Although Eve & Co has established a wide target market, we would like to see the company establish future distribution channels to other major provinces such as Alberta and British Columbia.

Canada Market by Province

		MEDICAL CANNABIS				ADULT-USE CANNABIS	
		2018		2024		2018	2024
	2018 POPULATION (000)	PATIENTS	SPENDING ($M)	PATIENTS	SPENDING ($M)	SPENDING ($M)	SPENDING ($M)
Alberta	4,330	106,378	$192.0	87,619	$144.0	$24.5	$797.8
British Columbia	5,016	16,098	$15.7	13,259	$14.4	$3.4	$707.9
Manitoba	1,357	14,708	$6.4	12,114	$12.8	$7.8	$170.7
New Brunswick	772	8,023	$8.4	6,608	$6.9	$6.3	$94.2
Newfoundland & Labrador	525	4,383	$6.3	3,610	$5.8	$5.3	$108.0
Nova Scotia	965	14,405	$13.2	11,865	$10.9	$12.8	$136.9
Ontario	14,411	172,406	$181.3	142,004	$164.0	$21.8	$1,847.7
Prince Edward Island	155	1,578	$1.3	1,300	$1.1	$2.5	$16.2
Quebec	8,422	11,737	$10.4	9,667	$9.5	$24.7	$694.4
Saskatchewan	1,166	9,179	$14.6	7,560	$11.2	$1.8	$180.4
Territories	123	397	$0.8	327	$0.7	$1.5	$26.5
Canada Total	37,243	359,292	$456.6	295,934	$381.4	$112.5	$4,780.8

Taken from Global News, Source: ArcView Market Research/BDS Analytics

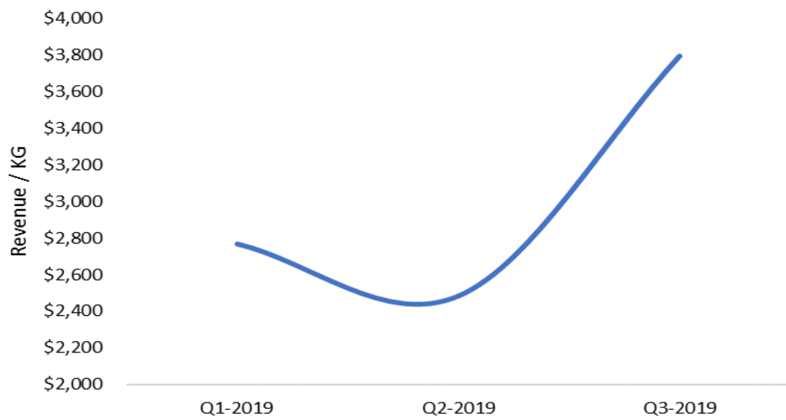
102% QoQ Increase in Revenue

As the company started revenue generation in Q1-2019, we have chosen to compare QoQ as opposed to year-over-year ("YoY"). **For Q3-2019, the company reported revenue of $0.92 million, a QoQ increase of 102%.** Revenue in Q3-2019 was generated through sales of 242 kg of dried cannabis flower and trim (compared to 183 kg of dried cannabis flower and trim in Q2-2019). The company attributed the large QoQ increase in kg sold to a bulk sales transaction made to the province of Newfoundland and Labrador. For the nine months ("9M") of 2019, the company reported revenue of $3.10 million. The following table shows historical revenue and average revenue per kg of dried cannabis flower and trim.

	Q1-2019	Q2-2019	Q3-2019	2019 (9M)
Revenue	$ 1,724,128	$ 454,701	$ 919,645	$ 3,098,474
Dried Cannabis and Trim (kg)	623	183	242	1,048
Revenue per kg of Dried Cannabis and Trim	**$ 2,768**	**$ 2,483**	**$ 3,797**	**$ 2,956**

Source: Company, FRC

Revenue per kg of Dried Cannabis and Trim



Source: FRC

Management has not provided segmented numbers for dried cannabis and trim, but **we believe that the increase in revenue per kg of cannabis and trim for Q3-2019, to be due to greater sales of dried cannabis flower** (which are higher revenue products).

Given the current state of the Canadian cannabis market and company disclosures that they will commence shipping cannabis products pursuant to its German supply contract in Q1-2020 (we had previously modelled this to commence in Q4-2019), we are revising our 2019 and 2020 revenue forecasts to $4.31 million (previously $7.25 million) and $47.88 million (previously $73.38 million), respectively. We are modelling for the company to conservatively sell 6,000 kg (previously 10,250 kg) of dried cannabis flower through its German supply contracts for 2020. We are revising our 2021 revenue forecast lower to reflect the push-out of the amount of dried cannabis flower sold through German supply contracts but are retaining subsequent years' revenue forecasts.

Deterioration in Gross Margin

The company's normalized gross profit for Q3-2019 (before adjusting for the change in fair value of biological assets) was $0.19 million (implying a gross margin of 20.84%). This compares to a gross profit for Q2-2019 of $0.18 (implying a gross margin of 38.61%). The EBITDA, EBIT and net margins turned negative in Q3-2019, compared to Q2-2019, due to changes in the fair value of biological assets (dried cannabis flower) being grown. We believe that pricing pressure in the Canadian cannabis market has resulted in Eve & Co having to reduce the fair value of its biological assets.

Margins	Q1-2019	Q2-2019	Q3-2019	2019 (9M)
Gross	47.30%	38.61%	20.84%	37.92%
EBITDA	-11.94%	83.86%	-212.80%	-57.33%
EBIT	-13.14%	79.34%	-215.20%	-59.37%
Net	-58.40%	79.95%	-212.80%	-83.61%

Source: Company, FRC

According to management, the deterioration in gross margins were caused by a lower number of high margin bulk sales transactions. We are revising our gross margin forecasts for 2019 and 2020 to 35.65% (previously 44.42%) and 42.59% (previously 58.73%), respectively. We are additionally revising our longer-term gross margin forecasts lower.

23% QoQ Decline in SG&A Expense

SG&A expense for Q3-2019 were $0.83 million, a QoQ decrease of 23%. The decline was primarily due to lower professional fees and consulting and contract work. For the 9M of 2019, the company reported SG&A expense of $2.42 million. Our 2019 SG&A expense forecast of $6.54 million appears to be too high, and we are revising this downwards to $3.37 million. We are also revising our 2020 SG&A expense downwards to $9.58 million (previously $14.68 million) to correspond with our downward revision on 2020 revenue. We believe that the company has yet to operate at full capacity and that SG&A expense could increase significantly in subsequent quarters to facilitate increased sales volume.

The company reported a net loss of -$1.96 million (EPS: -$0.01) for Q3-2019, compared to a net income of $0.36 million (EPS: $0.00) for Q2-2019. The deterioration in the bottom line QoQ was due to the fair value adjustment on biological assets. Our revised earnings forecast for 2019 and 2020 are -$4.36 million (EPS: -$0.02) and $6.88 million (EPS: $0.02), respectively. This compares to our previous earnings forecast for 2019 and 2020 of -$6.58 million (EPS: -$0.02) and $19.75 million (EPS: $0.07), respectively. Although we revised revenue lower for 2019, earnings improved due to a greater revision on SG&A expense.

Deterioration in Free Cash Flows due to CAPEX

Free cash flows ("FCFs") for the 9M of 2019 were -$25.77 million compared to -$16.16 million for the 9M of 2018. Deterioration in FCFs were primarily attributed to greater CAPEX in 2019 for the build-out of the company's facility. As the company reported that its 0.78 million sq. ft. expansion was completed in August 2019, we have assumed nominal CAPEX for the remainder of 2019.

Summary of Cash Flows ($, mm)	2018 (9M)	2019 (9M)
Operating	-$7.64	-$4.63
Investing	-$8.52	-$21.14
Financing	$18.55	$32.76
Effects of Exchange Rate	$0.00	$0.00
Net	**$2.39**	**$6.99**
Free Cash Flows to Firm (FCF)	**-$16.16**	**-$25.77**

Source: Company, FRC

Balance Sheet

At the end of Q3-2019, the company reported a cash position of $8.03 million, a working capital deficiency of -$4.21 million, a current ratio of 0.82x and total debt of $17.47 million. Company debt primarily relates to a $16.58 million draw against its $18.70 million construction facility.

(in C$) - YE Dec 31st Liquidity & Capital Structure		Q3-2019
Cash	$	8,031,996
Working Capital	$	-4,214,316
Current Ratio		0.82
LT Debt	$	-
Total Debt	$	17,466,494
LT Debt / Capital		-
Total Debt / Capital		0.34
Total Invested Capital	$	43,079,439

Source: Company, FRC

Stock Options and Warrants: We estimate that the company has 17.74 million options (weighted average exercise price of $0.31) and 37.57 million warrants (weighted average exercise price of $0.49) outstanding. Currently, 0.12 million options and nil warrants are in the money. The company will be able to raise up to $60,000 if all in the money options are exercised.

Valuation

DCF Valuation

Our updated Discounted Cash Flows ("DCF") valuation on Eve & Co's shares is $0.54 per share, versus our previous valuation of $0.92 per share.

DCF Model		Q4-2019E	2020E	2021E	2022E	2023E	Terminal
EBIT(1-tax)		$ -1,842,845	$ 7,729,439	$ 11,046,705	$ 14,940,669	$ 19,292,562	
Non-Cash Expenses		$ 760,297	$ 3,085,815	$ 3,954,294	$ 5,104,096	$ 5,961,471	
Investment in WC		$ 1,775,258	$ -3,158,893	$ -4,541,957	$ -5,530,327	$ -4,619,793	
CFO		$ 692,710	$ 7,656,362	$ 10,459,042	$ 14,514,439	$ 20,634,240	
CAPEX		$ -2,113,806	$ -1,888,940	$ -1,888,940	$ -1,888,940	$ -1,888,940	
FCF		$ -1,421,096	$ 5,767,422	$ 8,570,102	$ 12,625,499	$ 18,745,300	$ 19,307,659
PV		$ -1,381,399	$ 5,005,635	$ 6,641,183	$ 8,735,544	$ 11,580,193	$ 132,528,877
Discount Rate	12%						
Terminal Growth Rate	3%						
Total PV	$ 163,110,033						
Cash - Debt	$ -8,551,248						
Equity Value	$ 154,558,785						
Shares O/S (dil)	287,920,505						
Fair Value	**$ 0.54**						

Source: FRC

We reiterate our BUY rating and adjust our fair value estimate to $0.54 per share.

Risks

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

- The company operates in an industry that is highly regulated and subject to material change from governmental intervention.
- No guarantee that the company will be able to sell the cannabis produced at their facilities, nor successfully secure further long-term supply contracts.
- Contamination risk and other risks associated with biological/ agricultural production.
- Access to capital and share dilution.
- The company's licence to produce and sell cannabis has a term that ends of July 22, 2020. Any delay in the renewal process would have a severe impact on our valuation of the company.
- Liquidity risk.

We maintain our risk rating of 4 (Speculative).

APPENDIX

STATEMENTS OF OPERATIONS (in C$) - YE Dec 31st	2019E	2020E
Revenue	4,305,508	47,875,000
COGS	2,771,621	27,484,746
Gross Profit	**1,533,887**	**20,390,254**
Fair Value Adj. on Biological Assets		
Adj. Gross Profit	**1,533,887**	**20,390,254**
EXPENSES		
SG&A Expense	3,370,360	9,575,000
Share-based Compensation	1,512,470	1,196,875
EBITDA	**(3,348,943)**	**9,618,379**
Depreciation & Amortization	333,322	1,888,940
EBIT	**(3,682,266)**	**7,729,439**
Financing Costs	680,000	850,000
EBT	**(4,362,266)**	**6,879,439**
Non-Recurring Income (Expenses)		
Taxes		
Net Profit (Loss)	**(4,362,266)**	**6,879,439**
FOREX Translation Adj.		
Comprehensive Net Profit (Loss)	**(4,362,266)**	**6,879,439**
Shares outstanding	287,867,172	287,867,172
EPS	$ -0.02	$ 0.02

BALANCE SHEET (in C$) - YE Dec 31st	2018	2019E	2020E
ASSETS			
CURRENT			
Cash and Cash Equiv.	1,038,174	7,248,996	12,166,417
A/R	545,409	645,826	4,787,500
Inventory	2,075,368	6,402,337	7,181,250
Biological Assets	2,912,369	1,097,399	1,097,399
Prepaids	167,234	669,484	1,196,875
HST Receivable	1,889,568	1,762,383	957,500
Total Current Assets	**8,628,122**	**17,826,425**	**27,386,941**
PPE	14,860,255	37,778,802	37,778,802
Deposits		-	-
Total Assets	**23,488,377**	**55,605,227**	**65,165,743**
LIABILITIES			
CURRENT			
A/P	3,750,245	5,386,985	6,871,186
ST Debt			
Related Parties	976,000	976,000	976,000
Current Portion of LT Debt			
Other			
Total Current Liabilities	**4,726,245**	**6,362,985**	**7,847,186**
LT Debt	3,346,099	17,000,000	17,000,000
Total Liabilities	**8,072,344**	**23,362,985**	**24,847,186**
SHAREHOLDERS EQUITY			
Share Capital	23,447,576	34,018,532	34,018,532
Special Warrants		9,105,049	9,105,049
Contributed Surplus	2,704,901	4,217,371	5,414,246
Deficit	(10,736,444)	(15,098,710)	(8,219,271)
Total shareholders' equity (deficiency)	**15,416,033**	**32,242,242**	**40,318,556**
Total Liabilities and Shareholders Equity	**23,488,377**	**55,605,227**	**65,165,743**

STATEMENTS OF CASH FLOWS (in C$) - YE Dec 31st	2019E	2020E
OPERATING ACTIVITIES		
Net Profit for the Year	(4,362,266)	6,879,439
Adjusted for items not involving cash:		
Amortization	333,322	1,888,940
SBC	1,512,470	1,196,875
Shares for Services		
Finance Expense		
Biological Assets		
Deferred Tax		
Transaction Costs		
Funds From Operations	**(2,516,473)**	**9,965,254**
Change in working capital		
A/R	(100,417)	(4,141,674)
HST	127,185	804,883
Prepaids	(502,250)	(527,391)
Inventory	(4,326,969)	(778,913)
A/P	1,636,740	1,484,202
Biological Assets	1,814,970	-
Related Parties	-	-
NET CASH USED IN OPERATING ACTIVITIES	**(3,867,215)**	**6,806,362**
INVESTING ACTIVITIES		
PPE	(23,251,869)	(1,888,940)
Deposits		
NET CASH USED IN INVESTING ACTIVITIES	**(23,251,869)**	**(1,888,940)**
FINANCING ACTIVITIES		
Equity Issue	17,192,316	
Issue Costs	(862,410)	
Debt	17,000,000	
Convertible Debt		
Related Parties		
NET CASH FROM FINANCING ACTIVITIES	**33,329,906**	-
Foreign Exchange / Others		
INCREASE IN CASH FOR THE YEAR	**6,210,822**	**4,917,422**
CASH, BEGINNING OF THE YEAR	1,038,174	7,248,996
CASH, END OF THE YEAR	**7,248,996**	**12,166,417**

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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