



HIGH AND HIGHER: MAKING MONEY ON MARIJUANA!

The Cannabis Boom!

The times, they are a changing..

- In 1992, when Bill Clinton was running for president of the United States, and was asked whether he had ever smoked marijuana, he responded that he had, but that he did not inhale.
- Today, smoking marijuana recreationally is legal in nine states and medical marijuana in twenty nine states, in the United States. On October 17, 2018, Canada will become the second country (after Uruguay) in the world to legalize the recreational use of the product.
- In conjunction with this development, new companies are entering the market, hoping to take advantage of what they see as a “big” market, and excited investors are rewarding them with large market capitalizations.

A Preview of Canadian Legalization

- Lots of people smoke weed: According to the [Canadian national census](#), 42.5% of Canadians have tried Marijuana and about 16% had used it in the recent past (last 3 months), with the percentages climbing among younger Canadians, where one in three being recent users.
- And spend money to do so: The total revenues from recreational marijuana sales in Canada alone is expected to be \$7-8 billion in 2020 and grow at a healthy rate after that. Some of this will represent a shifting from the illegal market (estimated at close to \$5 billion in 2017) and some of it will represent new users drawn in its legal status.

Experience in Colorado & California

- In California, where legalization occurred at the start of 2018, revenues from cannabis are expected to be about \$3.4 billion in 2018, but that is not a huge jump from the \$3 billion in revenues in the illegal market in 2017.
- In Colorado, where recreational marijuana use has been legal since 2014, the revenues from selling marijuana have increased from \$996 million in 2015 to \$1,25 billion in 2016 to \$1,47 billion in 2017, representing solid, but not spectacular, growth. Cannabis-related businesses, though, have had trouble generating profits.

General lessons

- The illegal marijuana market will persist after legalization: Legalization brings costs, regulations and taxes, which make the cost of legal weed higher than its illegal counterpart. The other is cultural, where a segment of long-time weed smokers will be reluctant to give up their traditional ways of acquiring and using weed.
- There will be growth in recreational marijuana sales, but it will be moderate: For those who are expecting a sudden surge of new users, as a result of legalization, the results from the parts of the world that have legalized should be sobering. In most of these parts,
- The medical marijuana market growth will be driven more by research indicating its value in health care than by popularity contests. The bad news is that this will require navigating the time-consuming and cash-burning FDA regulatory approval process but the good news is that once approved, there is less likely to be pushback, cultural or legal, against its use. marijuana.
- Federal laws matter: If you are a company in the weed business in one of the nine states that has legalized marijuana, your operations may be legal in the state that you operate in, you are at risk any time your operations require you to cross state lines and as we noted with Colorado businesses, when you pay federal taxes.

The Business Question

- Not all big businesses are profitable or value creating, since for a big business to be value creating, it has to players with with competitive advantages or barriers to entry.
- If you are an investor in this space, you also have to start thinking about how companies will set themselves apart from each other, once the business matures.
- To see how companies in this business will evolve, it is important that you separate the recreational from the medical cannabis businesses, since each will face different challenges.

I. Recreational Marijuana

- Like tobacco and alcohol, the recreational marijuana business will grow with a wink and a nod towards its side costs and potential to be a gateway to more potent and addictive substances. Like tobacco and alcohol, marijuana will face both constraints and regulations.
- The question then becomes whether, like alcohol and tobacco, the cannabis will become a brand-name driven business, where having a stronger brand name allows the winners to charge higher prices and earn better margins or whether it devolves into a commodity business, where there is little to differentiate between the offerings of different companies, leading to commoditization and low margins.
- If it is the former, the most successful businesses in the space will bring marketing and branding skills to the table and if it is the latter, it will be economies of scale, and low-cost production that will be the differentiator.

II. Medical Marijuana

- The medical marijuana business will more closely resemble pharmaceutical companies, where the business will have to work with health care regulators and economics.
- Success in this business will come from finding a blockbuster cannabis-based drug that can then be sold at premium prices.
- If our experience with young pharmaceutical and biotech companies is an indicator, this would suggest that to succeed in this business, a company will need continued access to capital from investors with patience, a strong research presence and an understanding of the regulatory approval process.

Investment Considerations: The Landscape

<i>Company</i>	<i>Country</i>	<i>Market Cap</i>	<i>Price/Book</i>	<i>EV/Sales</i>	<i>EV</i>	<i>Revenues</i>	<i>EBITDA</i>	<i>EBIT</i>	<i>Book Equity</i>
Tilray	Canada	\$13,813.00	392.08	\$ 494.36	\$13,842.00	\$ 28.00	\$(17.70)	\$(19.50)	\$ 35.23
Canopy Growth	Canada	\$11,516.00	13.13	\$ 170.19	\$11,556.00	\$ 67.90	\$(64.20)	\$(80.40)	\$ 877.20
Aurora Cannabis	Canada	\$10,161.00	8.45	\$ 239.77	\$10,207.00	\$ 42.57	\$(52.33)	\$(61.87)	\$ 1,202.00
Aphria	Canada	\$ 3,677.00	4.10	\$ 127.40	\$ 3,627.00	\$ 28.47	\$ (0.51)	\$ (5.58)	\$ 897.74
Cronos Group	Canada	\$ 1,754.00	10.01	\$ 236.22	\$ 1,689.00	\$ 7.15	\$ (0.02)	\$ (1.12)	\$ 175.28
MedMen Enterprises	United States	\$ 2,520.00	33.53	\$ 87.64	\$ 2,574.00	\$ 29.37	\$(34.66)	\$(39.43)	\$ 75.15
The Green Organic	Canada	\$ 1,445.00	4.74	NA	\$ 1,183.00	\$ -	\$(24.35)	\$(24.91)	\$ 304.70
HEXO Corp	Canada	\$ 1,351.00	6.00	\$ 342.90	\$ 1,159.00	\$ 3.38	\$ (4.69)	\$ (5.21)	\$ 225.06
CannTrust Holdings	Canada	\$ 1,195.00	8.40	\$ 48.64	\$ 1,126.00	\$ 23.15	\$ 19.01	\$ 18.34	\$ 142.25
Auxly Cannabis	Canada	\$ 654.00	2.40	\$ 281.46	\$ 501.00	\$ 1.78	\$(23.90)	\$(23.97)	\$ 273.02

Be a trader!

- Like all young businesses, this segment is currently dominated by trading and pricing, not investing and valuation.
- Companies are being priced based upon potential market size and incremental information. Put simply, small and seemingly insignificant news stories will cause big swings in stock prices.
- If you are a good trader, this is a great time to play the game, since you can use your skills at detecting momentum shifts to make money as the stock goes up and again as it goes down.

Investor Choices

- The Concentrated Pick: Pick a stock or two that you believe is most suited to succeed in the business, as it matures. To succeed at this strategy, you have to be right on your macro assessment, but if you do, this approach has the potential to have the biggest payoff.
- Spread your bets: If your views about how the business will evolve are diffuse, but you do believe that there will be strong overall revenue growth and ultimate profitability, you can buy a portfolio of marijuana stocks. The upside is that you just have to be right, on average, for this strategy to pay off, but the downside is that these companies are all richly priced, given the overall optimism about the market today. You also have to worry that the ultimate winner may not be on the list of stocks that are listed today, but a new entrant who has not shown up yet.
- The Indirect Play: Watch for established players to also jump in, with tobacco and alcohol stocks entering the recreational weed business, and pharmaceutical companies the medical weed business. You may get a better payoff investing in these established companies, many of which are priced for low growth and declining margins.

My Choice!

- It may be indication of my age, but I really don't have a strong enough handle on this market and what makes it tick to make an early bet on competitive advantages. So, I will pass on picking the one or two winners in the market.
- Given how euphoric investors have been since the legalization of weed in Canada in pushing up cannabis stock prices, I think this is the wrong time to buy the ETF, especially since sector is going to draw in new players.
- That leaves me with the third and final choice, which is to invest in a company that is not viewed as being in the business but has a significant stake in it nevertheless. At current stock prices, neither Scott Miracle-Gro nor GW Pharmaceuticals looks like a good bet, but I think that my choices will get richer in the years to come. I can wait!