Marijuana - Bubble Index

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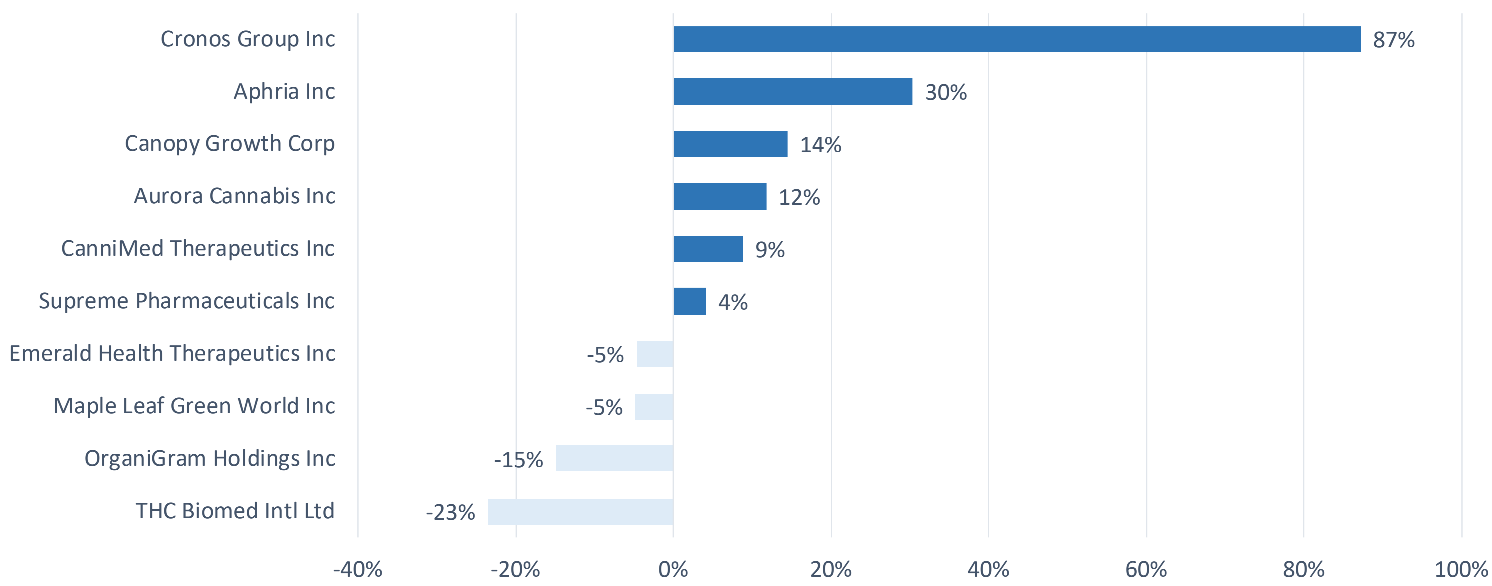
Canadian Cannabis Stocks Are Burning 'Higher' as the End of the 'Green Prohibition' Nears

This past year has seen big wins for the marijuana industry as in the U.S., Colorado crossed the $1 billion mark for annual marijuana sales, and in Canada, the Liberal government moves ever-closer to legalizing recreational marijuana use. As a result, licensed producers (LP) are racing to capitalize on the budding Canadian marijuana market, which has garnered significant investor attention. The value of the ever-increasing number of marijuana stocks listed on Canadian stock exchanges has swelled to over $5 billion from next to nothing a couple of years ago. Stocks on our Marijuana Stock Bubble 10 Index have rallied over 200% in the past year, begging the question: are we in bubble territory, or is this just the beginning of a growing industry?

In this edition of the Marijuana Stock Bubble Index, we take a look at the future of the cannabis industry, potential risks for the Canadian market, as well as the companies best positioned to 'burn higher' from marijuana legalization.

Industry 2017-YTD Performance



Source: Ubika Research

Industry Highlights

- The Liberal government will announce legislation next month that will legalize marijuana in Canada by July 1, 2018. The roll-out plan and legislation will follow the recommendations of the federally-appointed Task Force that was chaired by former Liberal Justice Minister Anne McLellan. Some of the guidelines presented by Ms. McLellan include control of sales by provinces, four plant per household limit, and setting the minimum purchase age at 18—or the provincial age limit for alcohol. More details of the recommendations can be found here.
- A report by NASEM found that cannabis can relieve symptoms of chronic pain, spasticity associated with Multiple Sclerosis, as well as nausea and vomiting associated with chemotherapy. On the other side, the report also found strong evidence that heavy use of marijuana can increase the chances of developing psychosis and respiratory problems. Needless to say, the bipolar nature of MJ's effects may deter new users once the rec. market opens its gates.
- Several LPs, including Tweed and RedeCan Pharm, have written a letter to Ottawa, urging the federal government to allow them to brand their products and provide medical cannabis on a tax-free basis. The Task Force, however, had recommended requiring plain packaging for cannabis as well as advertising restrictions. LPs argue that preventing them from branding their products makes it difficult for them to compete with black market operations and educate the public about different strains.
- A recent survey conducted by Environics Communications asked whether Canadians trust companies in each sector to "do what is right for Canada, Canadians, and our society." Only 13% of roughly 1,500 respondents gave marijuana LPs a rating of five or higher on a seven-point trust scale. The LP trust rating was lower than sectors such as pipelines, social media platforms, and pharmaceutical companies.

Upcoming Events

- O'Cannabiz Conference & Expo Conference and Expo: April 21st-23rd, hosted by MNP at the Sheraton Centre Toronto Hotel, Toronto, Ontario, Canada.
- Cannabis Life Conference: May 13th-14th, hosted by Cambridge House in partnership with the Cannabis Growers of Canada (CGC) at the Evergreen Brickworks, Toronto, Ontario, Canada.
- Lift Cannabis Expo 2017: May 26th-28th, hosted by Lift at the Metro Toronto Convention Centre, Toronto, Ontario, Canada.
- The Canadian Institute's Canadian Cannabis Business Conference: May 26th-27th, hosted by The Canadian Institute at the Hilton Hotel, Toronto, Ontario, Canada.

Unauthorized Pesticide Use in the Cannabis Industry

Big-name stocks in the cannabis industry have taken a blow recently due to banned pesticide use, which had required them to issue a recall for products ranging from concentrates to edibles. Pesticides can have serious and harmful effects on humans such as, but not limited to: cancer, liver damage, weakened muscle function, sterility, chronic illness, and poisoning (Figure 1). According to a study published in the Journal of Toxicology, 70% of the pesticides sprayed on a cannabis bud can transfer to inhaled smoke going straight to your lungs. Scientists estimate smoking a plant means you ingest about 10x as many pesticides as you eat. What's even more concerning, according to molecular scientist Mowgli Holmes, concentrated cannabis products such as shatter, oils, and hash increase the risk significantly more than oral doses.

Figure 1: 5 Pesticides Found in Cannabis and Their Effects on Humans

Myclobutanil	Allergic dermatitis, vomiting, itchiness, nausea, headache, skin rash, nosebleed, and eye irritation, reduced weight of newborns, and increased incident of stillborn
Imidacloprid	Fatigue, cramps, muscle weakness, twitching, dizziness, breathlessness, confusion, vomiting, skin irritation, apathy
Avermectin	CNS depression, incoordination, tremors, lethargy, excitation, pupil dilation
Etoxazole	Liver damage, anemia, body weight decrease, kidney damage, liver damage, adrenal gland damage, testicular damage
Bifenazate	Decreased body weight, decreased urinary volume, extramedullary hematopoiesis of the spleen

A class-action lawsuit has been launched against Canopy Growth Corp. (TSX:WEED) by a Halifax-based law firm over pesticide use in marijuana. Canopy Growth had acquired Mettrum earlier this year and had issued recalls of medical marijuana that contained an unauthorized pesticide, Myclobutanil. When heated, Myclobutanil can emit hydrogen cyanide, which can be deadly. The news has sent Canopy's stock down over 25% as investors await more details of the charges. This is not the first case of banned pesticide use by a producer, as Organigram Holdings Inc. (TSXV:OGI) and Aurora Cannabis (TSXV:ACB) experienced similar recalls.

For consumers, the widespread use of pesticides by LPs begs the question of whether medical cannabis is safer than marijuana sold on the black market. **Currently, licensed producers are stockpiling cannabis production ahead of legalization, set for July 2018. However, with a shelf-life of only 12 months, it is questionable what kind of preservatives or anti-aging chemicals producers will employ to prevent the need for massive write-downs of stock if cannabis legalization is further delayed.**

Considered by many to be a 'natural remedy,' perhaps ongoing incidents of banned pesticide use will encourage consumers to grow their own marijuana—the only way to ensure their medicine is untampered. Presently, Prime Minister Justin Trudeau's Task Force has recommended a limit of 4 plants per household, which can produce a yield ranging from 100-400 grams annually, depending on the grower's expertise and equipment. Such a shift would have a devastating impact on the potential rec. sales of LPs.

Notable Performers

Aphria Inc. (TSX: APH)

Aphria Inc. ("Aphria") is engaged in producing and selling medical marijuana and cannabis oil products through retail sales and wholesale channels. Aphria's retail sales are sold primarily via its online store in addition to phone orders. At a wholesale level, the Company sells to other LPs. In a high-growth industry with mind-boggling cash burn rates, Aphria is one of two profitable LPs to date; the other being Canopy Growth. In the past year, Aphria has surged over 30% as it continuously improves its operations to become one of the lowest-cost cannabis producers. As of March 22nd, Aphria has graduated to the TSX and is on the heels of Canopy Growth Corp.

Aphria has planned a four-part, 1,000,000 square foot expansion plan to achieve economies of scale and target production costs of under $0.80/gram, once Part-3 is producing in May 2019 (Figure 2). Part-1 is currently producing 2,500 kg/annually at a cash cost of $1.31/gram, which is 60% lower than its nearest peer (Figure 3). Construction of Part-2 is complete but awaiting approval, and is expected to expand production to 7,500 kg/annually. Part-3 is fully-funded

Figure 2: Total Marijuana Market Size Potential

PART II EXPANSION
(Ready for April 2017, pending HC approvals)
- 57,000 square feet @ $55 per square foot
- Grow to 100,000 square feet of production space
- $10 million project

FULLY FUNDED

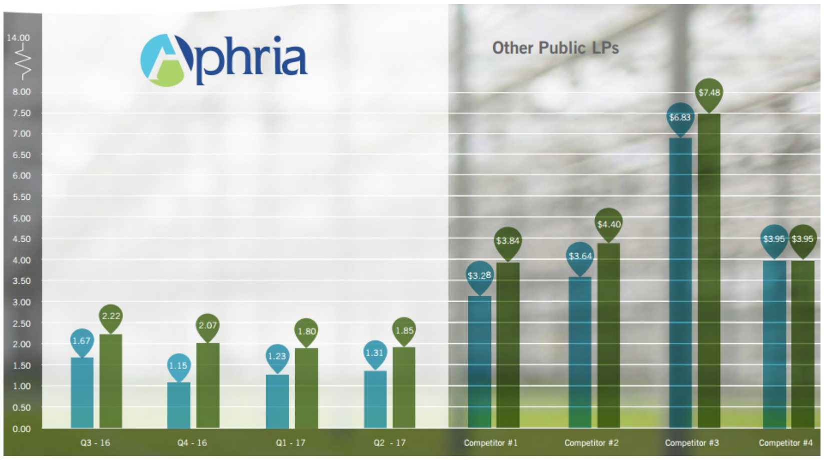
PART III EXPANSION
(Ready for April 2018, pending HC approvals)
- 200,000 square feet @ $55 per square feet
- Demolish and build to current Leamington greenhouse standards
- $24.5 million project

FULLY FUNDED

PART IV EXPANSION
(Ready for May 2019, pending HC approvals)
- 700,000 square feet @ $50 per square feet
- Build to current Leamington greenhouse standards
- $137 million project

Source: Investor Presentation

Figure 3: Aphria's Production Costs Per Gram vs. Peers

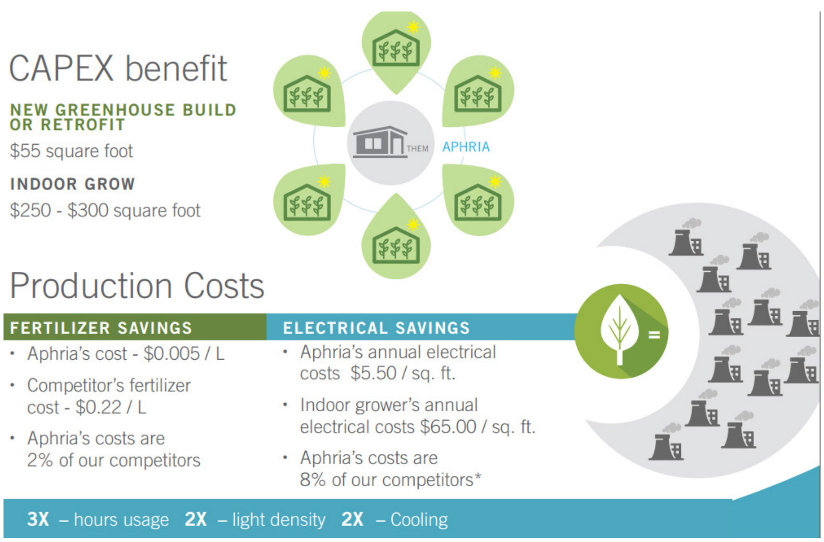


Source: Corporate Presentation (blue=cash costs, green=all in sustaining costs)

by cash and construction is currently underway. Upon completion in April 2018, Part-3 will increase Aphria's production to 21,000 kg/year at a cash cost of just $1/gram! Looking ahead to 2019, the massive 700,000 square foot Part-4 expansion will increase production to 70,000 kg/annually at a target cash cost of $0.80/gram.

Aphria's competitive advantage stems from its ability to reduce costs and automate procedures. There has been speculation that the Part-4 expansion will incorporate extensive automation and sophisticated environmental systems such as robotic planting machines and a 15MW solar

Figure 4: Aphria's Cost-Saving Competitive Advantage



Source: Investor Presentation

power generation plant. Currently, Aphria employs low-energy retrofit greenhouses that are 80% cheaper than indoor grow facilities, yielding industry-low fertilizer and electrical costs (Figure 4).

Aphria has potential for a large production capacity with low productions costs, and the operational scalability to dominate the wholesale cannabis market. From an operational standpoint, Aphria has increasing positive cash flows that are expected to grow significantly with its near and mid-term production plans. Aphria has increased its gross margins consistently over the past six quarters, from 37% in Q1/2016 to 77% in Q2/2017, and this trend is expected to continue as economies of scale are achieved. Quarter over quarter, Aphria has increased its revenues by 19% to $5.2mm in Q2/2017. With its established low-cost operations and attractive cash-flow potential, Aphria is trading in line with peers at a 17.7x forward EV to 2018 sales multiple, compared to its LP peer average of 17.0x. Looking further ahead, taking into consideration the impact of Part-4's expansion on cash costs and production, Aphria is trading at an even more attractive forward 6.3x EV to 2019 sales multiple.

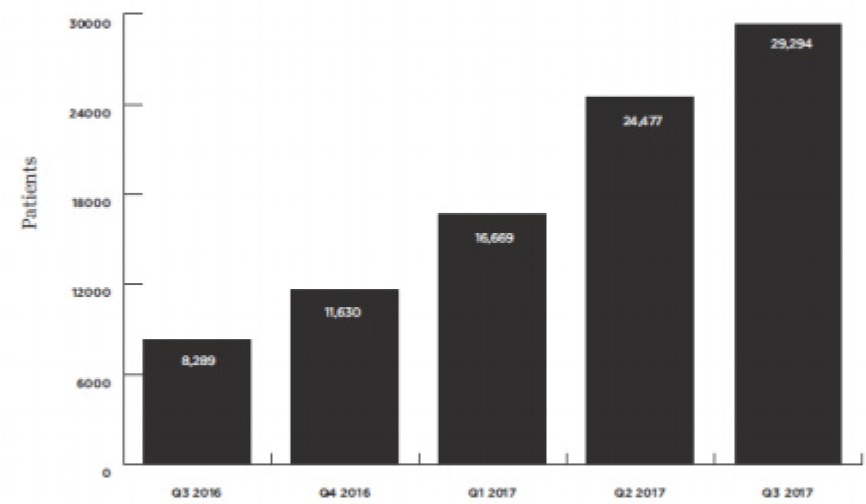
It is worth noting that this measure only considers sales metrics, and the market appears to be discounting Aphria's superior operational performance potential. Perhaps in the future, EV/EBITDA would be a more appropriate figure to compare LPs, once more stocks start producing and selling cannabis. Being a new industry, it is a challenge to compare Aphria to its peers, as major players in the industry are heavily investing capital for future growth and thus have yet to generate revenues—or even produce cannabis. As a result, valuations require speculation on future sales and production. In another view, we have performed a common size statement analysis of Aphria in comparison with Canopy Growth Corp and Aurora Cannabis using actual income statements, which can be found here.

Canopy Growth Corp. (TSX: WEED)

Canopy Growth Corp. ("Canopy Growth") is a diversified cannabis company with a multitude of brands and cannabis products ranging in strain varieties and potency. Canopy Growth owns several subsidiaries including Tweed and Bedrocan Canada, which were the first licensed cannabis producers in Canada, as well as Tweed Farms. The Company currently operates three production facilities with a combined total of 500,000+ square feet of indoor and greenhouse production capacity. Recently, Canopy Growth's stock took a 15% plunge as a result of a class-action lawsuit filed against it (recalled production from its acquisition of Mettrum Health Corp. was found to be contaminated with a banned pesticide). However, looking ahead, Canopy Growth is set to experience a new boost to its revenues as its e-Commerce website launches in the upcoming weeks.

In a recent statement, Canopy Growth stated that it had conducted thorough due diligence during the process of acquiring Mettrum Health Corp., and was aware of the extent and scope of the recall Mettrum was conducting. According to Health Canada, Mettrum's recall was classified as a Type III recall, which is defined as 'a situation in which the use of, or exposure to, a product is not likely to cause any adverse health consequences.' Nonetheless, news of a

Figure 5: Quarterly Growth in Canopy Growth's Registered Patients



Source: Sedar Filing

class-action lawsuit filing led to a dramatic sell-off of $400mm of the Company's market cap. The stock has since been holding steady as investors await further details pertaining to the lawsuit.

Commencing April 2017, Canopy Growth announced that its subsidiary, Tweed, will have a new online store called 'Tweed Main Street.' Currently there are over 50,000 Canadians registered with Canopy Growth, and the Company is targeting the increasing trend of online and mobile shopping, as it seeks to expand its footprint. The website is a strategy to synergize all of Canopy's subsidiaries under one platform; Tweed Inc, Bedrocan Canada Inc, and Mettrum Health Corp. This will not only reduce operating costs, but also benefit from cross-selling between the different products of the three subsidiaries in one convenient marketplace. Additionally, by launching an e-Commerce platform, Canopy Growth will be able to sell directly to its consumers, without having to depend on retailers, resulting in higher profit margins.

Canopy Growth's Q3/2017 financial results highlight the company's high-growth profile. The Company saw its registered patient base increase over 260% to 29,000 Y/Y as of December 31, 2016 (Figure 5) and reported revenues of $9.8mm for the quarter, a 180% increase over the same period last year. Production also set a new record of 5,264 kg in Q3/2017 compared to 1,711 kg in Q2/2017.

Perhaps most impressive is the fact that gross margin for Q3/2017 was 174% of revenue compared to 79% in the same period last year (Figure 6). Upon closer examination, the increase in gross margin is due to unrealized gain on changes in the fair value of Canopy's biological assets. Subtracting out the unrealized gain, Canopy's operating margin is negative!

As a plant grows from a seed to a seedling to a budding plant, its value increases and is added to the inventory—hence an unrealized gain. Tweed and Bedrocan's completed and planned grow rooms plus the expanded production capacity of Tweed Farms are expected to yield harvests that will produce increased volumes of available inventory, thereby improving operating margins.

Currently, Canopy Growth is trading at a forward 2018 EV to sales multiple of 12.8x, considerably below its peer licensed producer average of 17.0x. Considering its growth prospects, Canopy Growth appears to be undervalued, but the price cut may be due to the risk associated with the impending settlement of its lawsuit. With a cash balance of $92.5mm, Canopy has one of the strongest balance sheets in the industry, leaving the Company well-capitalized for further growth via organic or acquisition.

Figure 6: Impact of Adjusted Product Contribution on Gross Margins

CANOPY GROWTH CORPORATION				
Unaudited Non-GAAP Measure	Three Months Ended		Nine Months Ended	
(In CDN$000's, except gram amounts)	December 31, 2016	December 31, 2015	December 31, 2016	December 31, 2015
Adjusted Product Contribution[1]				
Weighed average cost per gram	$ 2.47	$ 2.29	$ 2.63	$ 2.68
Grams sold in the period	1,245,095	461,544	3,398,803	996,045
Revenue	$ 9,752	$ 3,481	$ 25,234	$ 7,657
Adjusted cost of sales	(3,075)	(1,059)	(8,939)	(2,672)
Adjusted Product Contribution	$ 6,677	$ 2,422	$ 16,295	$ 4,985
Adjusted Product Contribution percentage of revenue	*68%*	*70%*	*65%*	*65%*
As compared to the Gross Margin per IFRS:				
Gross margin	$ 16,943	$ 2,756	$ 36,215	$ 16,298
Gross margin percentage of revenue	*174%*	*79%*	*144%*	*213%*

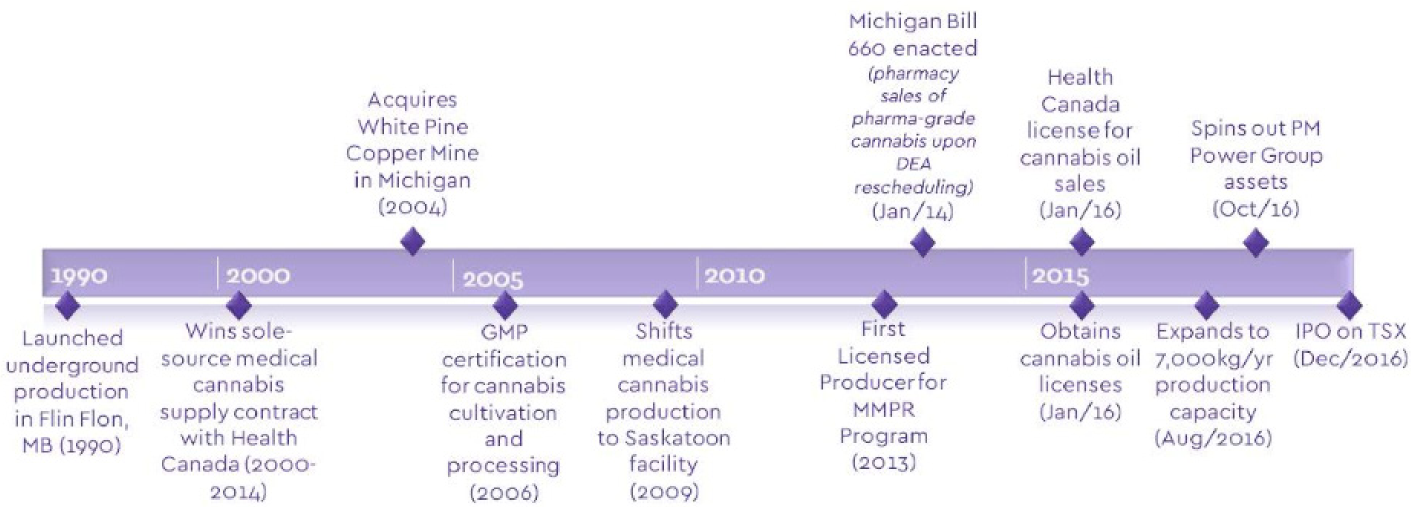
Source: Sedar

CanniMed Therapeutics Inc. (TSX: CMED)

CanniMed Therapeutics Inc. ("CanniMed") is a Canada-based plant biopharmaceutical company specializing in the production of medicinal-grade cannabis, offering a wide range of pharmaceutical-grade products. CMED has positive short and mid-term catalysts on its horizon including a wholesale supply contract with a major pharmacy, production reliability and scalability, as well as global expansion plans.

The Company has 15 years of pharmaceutical cannabis cultivation experience with Good Manufacturing Processes (GMP) compliant plant production processes, and was the sole provider of medical cannabis to Health Canada from 2000-2014 (Figure 7). From growing marijuana out of a mine 300 meters underground to receiving its GMP certification in 2006, CanniMed has the intellectual talent and experience to scale its production. In contrast to recent production struggles with major LPs, CanniMed has never faced contamination issues or product recalls. With the medical cannabis mail order market potentially reaching 100,000 kg/year (worth approximately $800mm/year at $8/gram retail), CMED is one of the best positioned LPs that can reliably scale production to meet demand.

Figure 7: The History of CanniMed Therapeutics



Source: Clarius Securities Inc.

CanniMed is the first licensed producer to sign a wholesale supply agreement with Pharmachoice, a Canadian pharmacy chain with over 700+ stores. With legislation expected to pass in 2018, pharmacies will create additional demand of 100,000 kg/year (worth approximately $500mm/year, $5/gram wholesale) as pharmacies begin to fill patient prescriptions. Presently, CanniMed has total production capacity of 7,000 kg of dried cannabis per year, more than its Health Canada license to produce and sell 5,000 kg/year. Total cannabis volume sold in Q1/2017 jumped 17% Q/Q to 340 kg, an annual run rate of 1,360 kg). Management expects demand to drive production to full capacity by the end of 2018. At the end of 2018, CanniMed expects its 5,000 kg/year production site in Saskatoon to be complete, bringing its total Canadian production capacity to 12,000 kg/year!

Cannimed is also aggressively pursuing export distribution agreements to expand its footprint as foreign markets—such as Germany, Australia, and Mexico—begin legalizing marijuana. As mentioned in our previous Marijuana Bubble Index issue, Cannimed's strategic advantage stems from its partnership with Creso Pharma Ltd. (ASX: CPH), a distributor of medical cannabis within the European Union. CMED aims to capture the market share of cannabis-savvy baby-boomers in the European Union, which has a population of 156 million compared to Canada's 9 million. With recent medicinal legalization in Germany and Denmark, CMED has bet on other European countries to soon follow suit. It has given Creso the rights to market CMED's line of medicinal cannabis products to governments, authorized importers and distributors, institutions, pharmacies, and individuals. Furthermore, Cannimed investors also get optionality on its production facility in Michigan, which is the only U.S. cannabis grow facility owned by a Canadian-licensed producer. Once the U.S. Drug Enforcement Agency reschedules cannabis, CanniMed's facility is well-prepared to begin supplying the newly-legalized market.

Currently trading at a forward 2018 EV/Sales multiple of 10.4x, CMED may be trading undervalued in comparison to other licensed producers, which trade at 17.0x. In conclusion, CanniMed appears to be a promising licensed producer with high-growth opportunities to expand its business with strategic partnerships in emerging cannabis markets such as the European Union.

Bubble Radar

No words can describe how large the investor appetite is for the soaring pot market in Canada. Backed by analyst estimates of 3.8 million recreational marijuana users by 2021, it almost guarantees billions of dollars of annual sales. Interestingly, retail investors are not the only ones buying cannabis companies. Canopy Growth has become the 'Pac-man' of the industry, fueling its growth through strategic acquisitions, such as Mettrum earlier this year. With a market value nearing $2B, Canopy Growth has become the world's largest cannabis company. Other stocks on our Marijuana Stock Bubble Index, such as OrganiGram and Supreme Pharmaceuticals, have rallied over 250% in the past year, but have yet to generate revenue or become profitable. Red flags are rising left, right, and centre, but are these signs of a bubble that may soon burst?

Figure 8: Marijuana Stock Bubble 10 - comparison table

Company Name	Ticker	Price	YTD Price % Change	Market Cap (CAD mm)	Sales (CAD mm)	EV/Sales	
					NTM	NTM	NTM+1
Canopy Growth Corp	WEED.TO	10.65	14%	1,694	125.7	12.8x	4.8x
Aphria Inc	APH.TO	6.71	30%	820	41.2	17.7x	6.3x
Aurora Cannabis Inc	ACB.V	2.58	12%	817	99.7	7.8x	3.6x
Cronos Group Inc	MJN.V	2.78	87%	365	21.8	16.7x	4.9x
CanniMed Therapeutics Inc	CMED.TO	11.65	9%	263	27.9	10.4x	5.1x
OrganiGram Holdings Inc	OGI.V	2.55	-15%	250	26.4	8.7x	3.3x
Supreme Pharmaceuticals Inc	SL.CD	1.50	4%	234	18.7	11.0x	3.5x
Emerald Health Therapeutics Inc	EMH.V	1.28	-5%	97	1.9	51.3x	-
THC Biomed Intl Ltd	THC.CD	0.75	-23%	76	NULL	-	-
Maple Leaf Green World Inc	MGW.V	0.61	-5%	75	NULL	-	-
Average:						**17.0x**	**4.5x**

Source: Ubika Research

Although the Liberal government has provided a timeline of introducing legislation in the upcoming weeks, with the goal of marijuana legalization on July 1st, 2018, there are still many unknowns. How will Canada regulate the sale of cannabis products? Will Canada use crown corporations such as the LCBO to distribute marijuana or will retail stores and LPs be allowed to distribute? What will the tax rate be for marijuana? Will the tax rates be different across different cannabis products or use; recreational vs medical? All of these aforementioned questions have an impact on the bottom line of each and every cannabis company. With so much uncertainty and sky-high valuations, there is the potential for this bubble to pop, hard!

Analysts estimate 20-30 more licenses to be granted in the next two years, which would double the current number of LPs. In response, LPs are racing to increase their production to gain market share of the budding Canadian market and the global trend towards legalization. Aurora Cannabis, for example, has started construction of its 'Aurora Sky' greenhouse, an 800,000 square feet facility in Alberta with projected annual production capacity of over a 100 million grams! In addition, LPs are going through a learning curve as they improve their operations, increasing their yields. Presently, there is a bottleneck on the supply side, however projects such as the Aurora Sky have the potential to flood the market in a few years. **Furthermore, there is also the threat of the black market to undercut LPs to maintain their footprint as well as the impending risk of home-cultivation.** Both the black market and home cultivators benefit from the lack of regulatory requirements as well as cost savings from licensing, overhead, taxes, etc., which give them an advantage to compete.

Like the supply-demand dynamics of any commodity, an over-supplied market will lead to depressed prices and, hence, tighter margins. How long would such a low-price environment last? Nobody knows. If LPs decided to engage in a price war, things could get ugly, real fast! With a significant proportion of pot stockholders being company insiders, the green market could crash if they decide to take profits.

As with all investments, past performance is not a reliable measure of future returns. The cannabis stocks in our Marijuana Stock Bubble Index have enjoyed substantial gains over the past year. **Looking forward, being a relatively new and untested industry, the high evaluations and forward revenue expectations from a speculative high-growth industry are unprecedented. Compounded with political, legal, health, and social risks, the future appears volatile for the cannabis industry. By focusing on fundamentals, Aphria Inc. appears to be the ahead of the budding race,** now that Canopy Growth is facing headwinds. With an experienced management team, largest footprint in the industry, well-capitalized top quality assets, and not to mention, a profitable business, Aphria appears to be the golden ticket to the Canadian green rush!

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