Marijuana - Bubble Index

May 8, 2017

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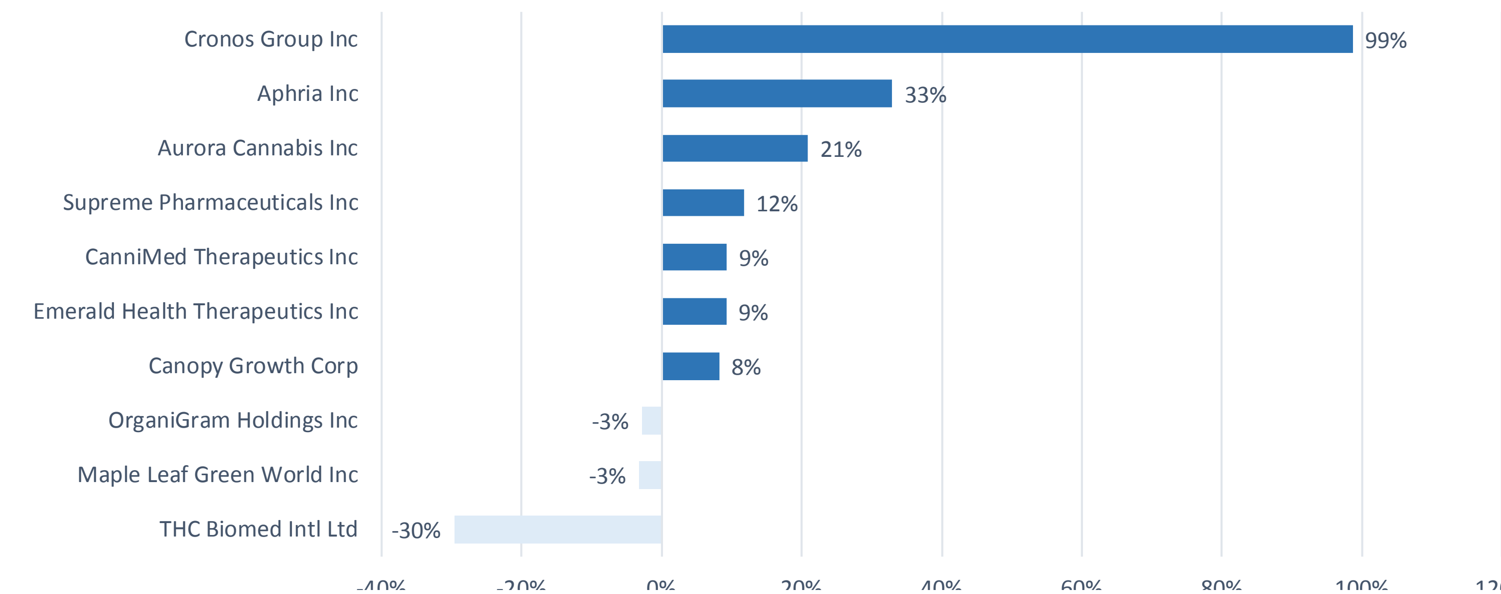
Marijuana Stocks Continue to Rise, but are Investor Hopes for the Industry Too High?

The Marijuana industry has performed exceptionally well this year, as countries all over the world are adopting more relaxed marijuana laws due to people becoming increasingly open to the herb. On the Canadian side, big news came from Ottawa as the Liberal Government released their proposed law to legalize and regulate recreational marijuana. There are now over 40 publicly-listed marijuana companies in Canada, comprising a total market value of over $5B. Stocks in our Ubika Index have increased over 200% on average this year, which makes you wonder, are high valuations justified by growth prospects, or has investor speculation gotten out of control?

In this edition of the Marijuana Stock Bubble Index, we look at how the proposed bill from the Trudeau government will affect the market in the short and long term, and which companies are best positioned to succeed in this ever-growing market.

Industry Performance (2017-YTD)



Source: Ubika Research

Industry Highlights

- Most recently, Germany passed a new "Cannabis as medicine law", which came into effect last March. The estimated US$22.6 billion marijuana market continues to impress, as one report by Forbes states the industry will create more jobs than manufacturing by 2020.
- The Liberal government has released their proposed Cannabis Act, which is sure to have a big impact on the market. The Act seeks to keep marijuana out of the hands of people who are under 18, reduce the burden on the enforcement/ justice system, maintain the medical access system, and remove profits from the illegal market. Most importantly, the Act seeks to place restrictions on promotional activity, and give the Provinces and territories the power to license and oversee the distribution and sale of cannabis. The full act can be found here.
- Finance Minister Bill Morneau hinted Ottawa would keep pot taxes low to stay competitive with black-market prices. He also stressed maximizing government revenue from marijuana sales is not a priority.
- Multiple new listings of marijuana companies on various North American exchanges, including: Horizons Medical Marijuana Life Sciences ETF (TSX:HMMJ), WebMD (NASDAQ:WBMD), Invictus MD Strategies Corp (TSXV:IMH), CanadaBis Capital Inc (TSXV: CANAB.P), ABcann (TSXV:ABCN),
- Ottawa has said edibles won't immediately be legal for sale once the Cannabis Act becomes law. In a report found here, the government said it will take time to develop and implement regulations that make the consumption of edibles safe. Edibles have proven to be in high demand, as sales increased 50% in Colorado from 2015 – 2016.
- A new report from the Globe and Mail details that adults 70+ are happy to switch to cannabis for treatment of chronic pain, anxiety, insomnia, and anxiety after they realize the benefits from the drug.

Upcoming Events

- Inaugural Cannabis Natural Education & Business Conference: May 5th-6th, Winnipeg, Manitoba, 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.
- Canadian Cannabis Business Conference: May 24th – 25th, presented by the Canadian Institute, at Hyatt Regency, Toronto, Ontario, Canada.
- Life Cannabis Expo 2017: May 26th – 28th, hosted by Lift at the Metro Toronto Convention Centre, Toronto, Ontario Canada.

Expect Industry Consolidation Due to Proposed Legalization Bill

The Canadian Marijuana industry is ripe for consolidation as companies seek to expand production capacity and diversify their domestic footprint in time for legalization. The proposed bill gives provinces and territories the power to license and oversee the distribution and sale of cannabis, it also gives them power over the legal age to consume cannabis. This looks a lot like Canada's Importation of Intoxication Liquors Act, in which the only way you can get liquor from one province to another is with the permission of the provincial liquor control board. This means companies may seek acquisitions across multiple provinces to hedge against the risk each province or territory will implement the legislation in different ways or at different times.

Furthermore, it is logical to see consolidation in the industry as companies try to build up production capacity in time for legalization. Legalization will bring a rapid increase in demand so companies must try to keep up with this demand by increasing how much bud they can produce per year. Since organically expanding production capacity is a timely process, it is more logical for companies to expand through acquisition as it is a quicker way to build up capacity. We have already started to see this in the industry as Canopy Growth Corp recently acquired rTrees Producers in Yorkton, Saskatchewa n for an initial amount of $7.4MM and full amount of $37.2MM upon completion of all milestones. This gives Canopy a 90,000 sq. ft faculty with the capacity to expand operations to over 300,000 sq. ft. For more on the deal click here. Furthermore, Aurora Cannabis acquired Montreal-based Peloton Pharmaceuticals, a late state ACMPR-applicant, for $7MM. Peloton is completing the construction of a state of the art 40,000 sq. ft. cannabis production facility that has the capacity to produce 3,900 kg of high-quality cannabis per year. Aurora management believes the facility is 80% complete. For more on the deal click here.

Companies in the Canadian Marijuana industry have easy access to capital, as investors have happily thrown money at marijuana producers due to the positive outlook of the industry. The formula for consolidation is ripe as companies look to geographically diversify, expand production capacity before the spring, and have easy access to capital. Soon, the industry could look very different as it appears to be shifting from a fragmented one made up of many small companies, to one dominated by few large players.

One logical takeover target is Aphria, as they are the most profitable marijuana company, and is trading at a low EV/Planned capacity ($12.42 vs index avg of $17.06), has a healthy balance sheet, has geographically diversified distribution networks and is undergoing a massive facility expansion that will be ready in line with recreational legalization. This makes them attractive, as potential acquirers would be able to derive cost synergies through vertically-integrated distribution networks, and expand production capacity before legalization.

Notable Performers

OrganiGram Holdings Inc. (TSXV:OGI)

OrganiGram is down 3% year to date due to a voluntary recall of certain strains of their medical marijuana product produced between August and December 2016. This recall resulted in over $2mm in sales credits and a $1.3mm write down in inventory. Since then, the Company has appointed a new CEO, and taken new strategic actions to distribute "Canada's safest Cannabis." Furthermore, the Company has great near-team growth catalysts and is well positioned to take advantage of the legalization of recreational Marijuana in Canada.

Newly-appointed CEO, Greg Engel, has stated his commitment for implementing company-wide initiatives that will help aid it with its new goal of becoming Canada's safest Cannabis company. These initiatives include full transparency and increased quality control. Quality control is essential for any product in which a consumer puts into their body, as nobody wants to feel at harm when consuming a product. When Maple Leaf Foods products were linked to a listeriosis outbreak in August 2008, the Company's stock fell over 20%; by early December 2008 the stock had recovered to its pre-outbreak levels. The stock has since gone up by 300%+ to ~$34/share, which shows how quickly consumers forget about situations like these, and how willing they are to put their trust back into the company. Based on this logic, OrganiGram should be valued on adjusted sales (Sales less sales credits). Doing so we can see that OrganiGram has adjusted sales of $7.3mm, valuing them at an EV/Adj Sales of 36.0x times, well below the index average of 52.6x.

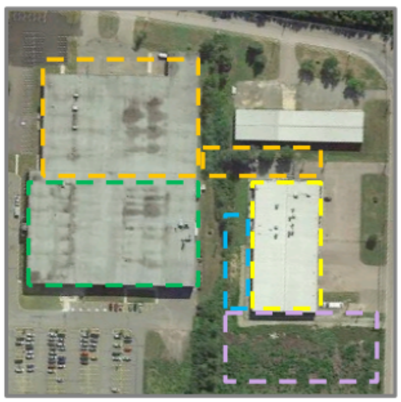
Figure 2: Maple Leaf Foods Stock Price

Source: Google Finance

The Company has great short-term growth catalysts as they have made significant progress towards increasing their production capacity of medical marijuana, cannabis oil and related products in preparation for the legalization of recreational marijuana use in Canada. In the most recent quarter, the Company closed a $40mm bought deal financing for completing an onsite expansion, which is expected to bring production capacity to 26,000 kg/year. The project is expected to finish in the Spring of 2018, right in line with the legalization of recreational marijuana in Canada.

Figure 3: OrganiGram Capacity Expansion

Expansion Overhead View



Expansion Specifics

Phase	Status	Completion Date	Area
Phase 1	Completed		31,160
Phase 2	Under Construction	Feb. '17	6,706
Phase 3	Under Construction	Oct. '17	81,673
Phase 3A	Under Construction	Oct. '17	13,746
Phase 4	New Building	Feb. '18	35,715
	Leased Space		58,503
Completed Total Area (Sq. Ft.)			**227,503**

Source: OrganiGram January 2017 Investor Deck

Furthermore, on April 10, 2017, the Company signed a letter of intent to acquire all the issued and outstanding shares of Trauma Healing Centers, a company who specializes in medical cannabis and prescribing. The acquisition is key to the Company's corporate strategy of vertical integration and patent onboarding. Due to short-term growth prospects, the Company expects to grow sales by 275% by next year.

The Company has entered into a licensing agreement with TPB productions, better known as the people who brought us the hit TV series "Trailer Park Boys ." They will become their exclusive Canadian Cannabis producer and business partner and developer. It should also be noted that two beloved character from the show, Mr. Lahey (played by John Dunsworth) and Randy (played by Patrick Roach) will be attending the Cannabis Life conference later this week! The Company stated this partnership was done in order to develop branding, packaging and a competitive portfolio targeted towards recreational marijuana consumers. Canopy Growth Corp. has displayed how powerful branding can be in the space through their partnership with Snoop Dogg.

The Company has a 12.0 current ratio and a Debt/NTM EBITDA ratio of 0.5, meaning they are in a great position to meet short-term and long-term obligations. Furthermore, the Company has $55mm of cash and short-term investments on hand. The Company's high liquidity and sufficient reserve of cash positions them well for growth.

Cronos Group Inc. (TSXV:MJN)

Cronos Group has been the top performer on the Ubika Index this year, as their stock has risen 99% YTD. In 2016, the Company shifted their corporate strategy from being a passive holding company to being an active owner and operator of their wholly-owned subsidiaries Peace Naturals Project Corp, and In the Zone Produce Ltd. The Company's newly-appointed and experienced management team has put it at an exceptional operational and strategic position, as they have focused on optimizing and ramping up production at their wholly-owned subsidiaries, and increasing domestic and international distribution networks.

Figure 4: Cronos Group Management Team

Source: April 2017 Investor Presentation

Peace Naturals Project Corp. was acquired in late 2016. It has a 38,000 sq. ft. production facility located on a 90-acre parcel of land in southern Ontario, giving them 80+ acres of flat land appropriately zoned for future development. The Company has recently undergone renovations, which added ~1,200 kg of production capacity and made the plant Good Manufacturing Practise ("GMP") certified. The plant has a capacity of 4,000 kg, in which they are currently licensed to sell 2,500kg, implying the Company will be able to expand margins through operating leverage if the government grants them the ability to sell more marijuana. Figure 5 illustrates how much land the Company has to expand on.

Figure 5: Cronos Group South Ontario Land

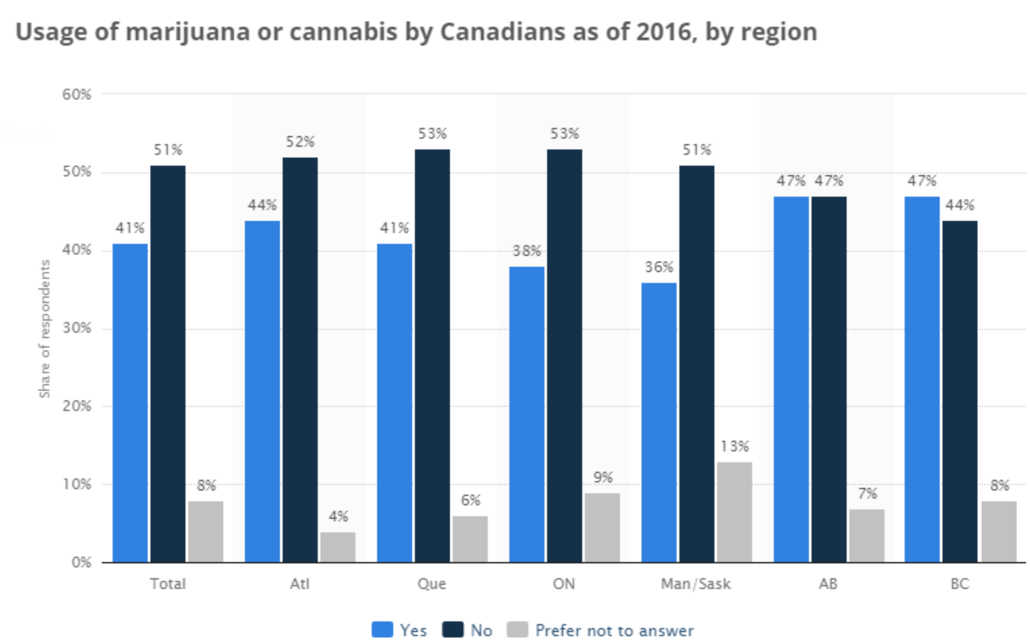
Three production buildings with 40,000+ sq. ft.

Situated on over 90 acres of land

Source: April 2017 Investor Presentation

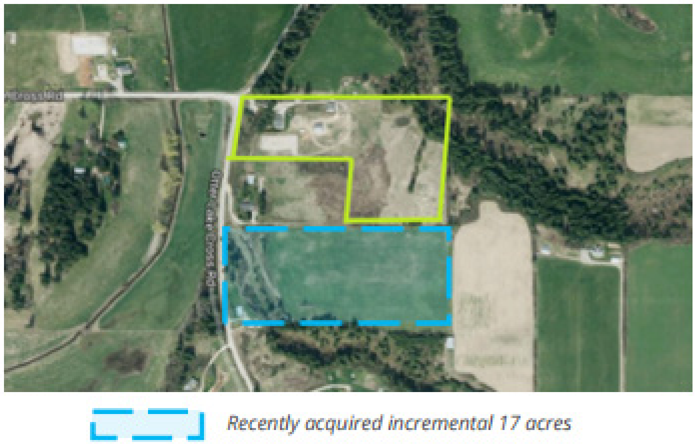
On the other hand, In the Zone Produce Inc., is a licenced producer based in Okanagan Valley, BC. They currently licence a 2,000 sq. ft facility, and are licenced to sell 100 kg/year. The Company just purchased the adjacent 17-acre property, and the plant sits on 31 acres of land, which is zoned appropriately for expansion. This is a key location due to the number of people who use cannabis in B.C. as seen in Figure 6.

Figure 6: Usage of marijuana by Canadians as of 2016, by region



Source: Statista

Figure 7: Cronos Group Okanagan Valley Land



Source: Cronos Group April 2017 Investor Presentation

Additionally, Cronos Group owns a 21.5% interest in Whistler Medical Marijuana Corp., which currently operates a licensed facility of 12,000 sq. ft. and is licensed to produce 700 kg/year. The Company has great growth prospects, as it has recently announced plans for a two-phase expansion. Phase One consists of a 65,000 sq. ft purpose-built facility, which the management estimates to have a capacity of 6,500 kg/year. Phase Two consists of an 80,000 sq. ft facility and an option to purchase 160 acres of neighbouring land. Whistler is also an iconic marijuana destination, which adds to the significance of this ownership stake.

Aphria Inc. (TSX:APH)

Aphria is a Canadian company that sells medical cannabis products online and over the phone. Its stock price is up 33% YTD. This comes as no surprise, as the Company has been profitable for five straight quarters, and is well positioned to grow domestically and internationally.

The Company's largest domestic growth opportunity comes from their business expansion known as Phase IV. This project is expected to increase their growing capacity from 300,000 sq, ft to 1,000,000 sq. ft. and is expected to increase their production capacity from 8,000 kg to 75,000 kg. The project is expected to be completed by the time recreational marijuana use is legalized in Canada, giving them an advantage over companies who do not have the proper infrastructure in place to meet the increase in demand from legalization. Here is a photo from the Company's 2016 annual report outlining the expansion. It should be noted that Phase III and IV are now fully funded.

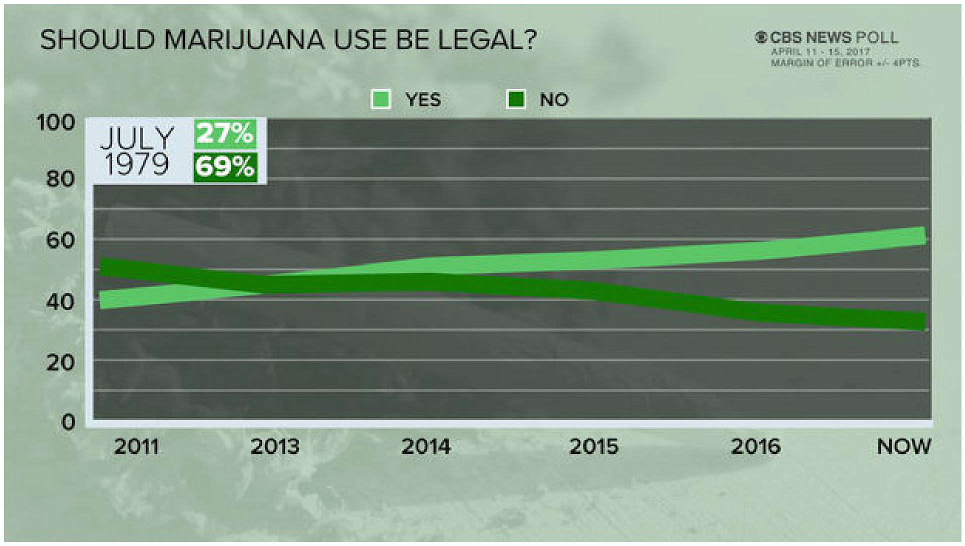
Figure 8: Aphria Production Expansion

Source: Aphria 2016 Annual Report

More organic growth opportunities come in the form of joint ventures in Quebec and the Maritimes, which will enhance brand visibility and give them distribution networks in these provinces. This is key as provinces will have control over how cannabis is distributed, so it is essential for companies to diversify geographically. The Company expect this JV to initiate operations in early summer 2017, with revenues being realized in Q1/2018.

Only four Canadian companies currently sell marijuana globally, and Aphria is best positioned to service the global market. This is due to their large cost advantage. A recent CBC report shows that 61% of people living in the U.S. think that marijuana should be legal, up from 40% just six years ago. If this trend continues it would not be surprising to see wide-spread adoption of recreational marijuana legalization in the U.S. Aphria is well positioned to serve this $7B market, due to their low-cost advantage and distribution networks set up in Arizona. The Company also has an arrangement to grow and prepare marijuana for Medlab, a company based in Australia. The Company's early entrance into international markets allows them to build up relationships with foreign business and government's necessary to succeed in the cannabis industry. This will only increase barriers to entry for players entering the market later.

Figure 9: U.S. Marijuana Trend



Source: Ubika Research

Aphria has a strong balance sheet with extreme liquidity and a low amount of debt. They have a 27.0 current ratio, and have enough cash and cash equivalents alone to cover their debt more than 9x over. The Company has a debt/EBITDA ratio of 3.5, meaning they will have no problem paying their debt. This Company isn't going anywhere soon, and when they put that cash to good use, as they intend to, funding their 700,000 sq. ft, expansion of their production facility, it could result in astronomical growth.

Bubble Radar

Increasing large valuations show the optimism investors have for the projected $22.6B Canadian marijuana industry. Valuation alone shows us the industry is in bubble territory, as stocks in the index are trading at an average 52.6x sales. Not to mention that many companies in the industry are pre-revenue, meaning investors are confident of market growth. This is akin to the U.S. Dot-com bubble in which valuations were based on revenues that some companies had no active plans of generating. The difference with the marijuana index is that all companies have active plans to generate profits, however these plans depend on them obtaining a license from the federal government.

Although questions are starting to be answered, clearing a bit of the uncertainty surrounding the industry, the level of uncertainty remains high. As mentioned above, Finance Minister Bill Morneau hinted at keeping taxes on marijuana low, which will certainly increase demand as producers will be able to keep prices competitive with black-market distributors.

Although the government published their proposed legislation, they left many questions unanswered such as:

- What will the packaging and labelling requirements be? All the Bill says on this front is that the product and promotion of it cannot be appealing to youth.
- How will cannabis be distributed?
- Will Crown Corporations distribute it, can it be distributed in corner stores? Drug stores?

These questions will be left up to provincial governments to decide.

The regulatory nature of this industry has big implications for producers in the sector, as the rules impact growth potential, market share opportunities, cost of incremental market share, and margin positioning along the value chain. The tightly-regulated nature of the industry coupled with high valuations means one move by the government can cause the bubble to burst at any moment, providing a significant amount of risk in investing in marijuana stocks.

There are few companies in the index that can be justified as "growth at a reasonable price." Most notably, Canopy Growth Corp, Cronos Group, Aurora Cannabis, and Organigram. They are all trading at an EV/Sales multiple lower that the index average, and are all expected to more than double sales this year. We believe these companies have the greatest risk/reward relationship as they provide less down-side risk with a significant amount of upside potential.

The Canadian marijuana industry is propped up by investor speculation of future profits and the industry is new and investors are resilient to analyse companies on fundamentals. The cannabis industry could be headed for choppy waters in the future due to the significant amount of political, social, legal, and health risks. The fundamental investor may want to steer clear of the industry all together, however if the prospects of future returns are too enticing, we suggest taking a basket approach to stock selection. With Organigram, Canopy Growth Corp, Cronos Group, and Aurora Cannabis, these are the stocks that can still provide returns with limited downside relative to the rest of the stocks in the index.

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