Marijuana - Bubble Index

June 26, 2017

Marijuana - Stock Bubble Index
May 8, 2017 - June 26, 2017

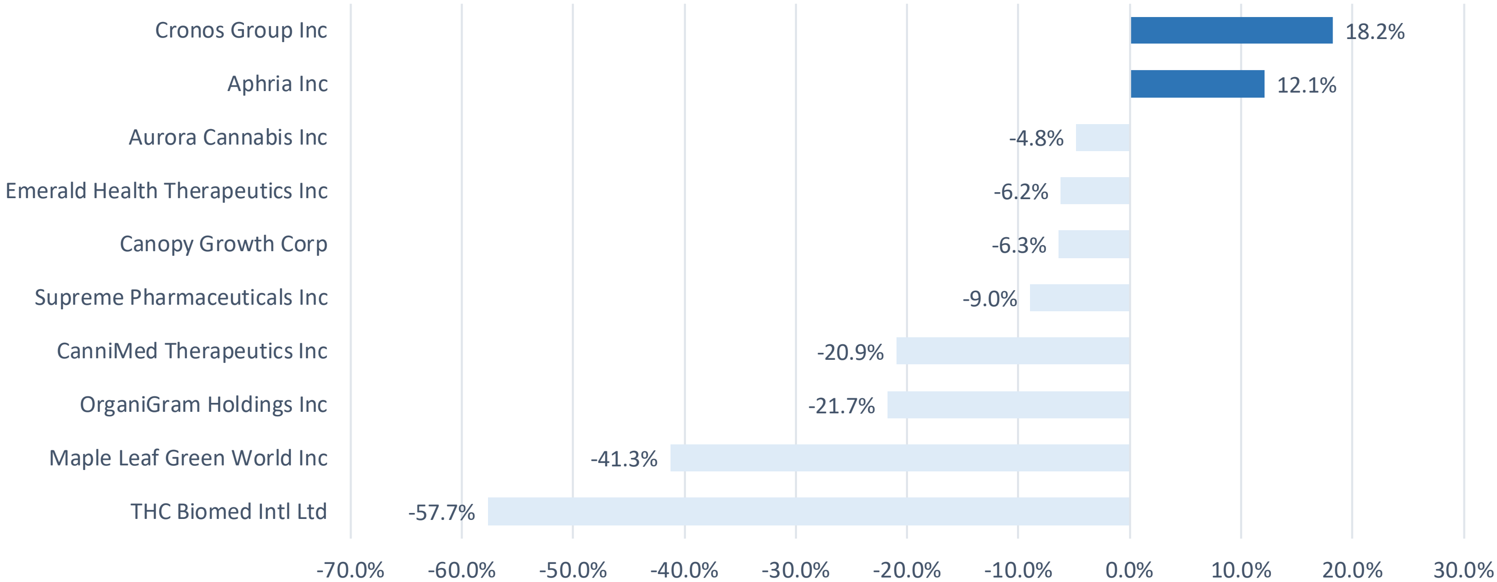
Alex Cutulenco | Senior Analyst | Gravitas Financial Inc. | alex@gravitasfinancial.com | 1 (416) 992-6731
Thomas Chapman | Analyst | Gravitas Financial Inc. | thomas@gravitasfinancial.com | 1 (647) 802-4556

Table of Contents

Marijuana Stocks Fall, Will the 'Buzz Kill' Continue?

The tides have turned, and the boy who cried wolf is finally right. The Ubika Marijuana Stock Bubble Index is seeing serious red in 2017, **with stocks dropping 14% on average** since the start of the year. The decline in the industry is likely due to a number of factors, including: an increasingly crowded sector, which now boasts 226 marijuana stocks; overall investor fatigue for early marijuana stock investors; uncertainty regarding product recalls, with Health Canada cracking down on pesticide use; questions surrounding recreational marijuana use, regulations that are still unanswered; as well as investors becoming more aware of the bubble-like valuations the industry exhibits.

Industry Performance (2017-YTD)



Source: Ubika Research

Industry Highlights

- **The Canadian federal government is sticking with its deadline to legalize recreational marijuana by July 2018**, despite concerns from provincial governments. Manitoba's finance minister, Cameron Friesen, expressed concerns with the deadline, stating that provinces are bearing all the work and costs needed to create a regulated cannabis market. Despite pushback from provincial governments, Prime Minister Justin Trudeau stated it is time to move forward on the act. It appears that pot taxation is the main issue. Canadian Finance Minister Bill Morneau stated that the challenge is identifying a price level at which prices are high enough to cover government costs, but low enough to eliminate the black market.

- **On July 1, 2017, recreational pot sales in Nevada are set to commence.** Nevada voters approved recreational marijuana with 54% of the vote last November. Only existing medical marijuana establishments that are operational and found to be in good standing will be allowed to sell marijuana on July 1st. As more States adopt relaxed marijuana laws, further value would be unlocked from the forecasted ~$60 billion U.S. Marijuana market. There is currently great uncertainty about the July 1st start date after a judge extended a temporary order preventing the State from issuing distribution licenses to existing marijuana businesses. Nevada regulators, however, remain determined to meet the July 1 start date.

- **On June 16, 2017, Nevada-based marijuana producer Friday Night Inc. (CSE: TGIF) listed on the Canadian Stock Exchange.** The Company issued 130mm shares at $0.195 per share for a total of $25mm. The stock closed at $0.325 on opening day, representing a gain of 67%.

- **On April 5, 2017, the first marijuana ETF debuted on the Toronto Stock Exchange.** The objective of the ETF is to mirror the return of the North American Medical Marijuana Index. The ETF is comprised of 11 companies listed in Canada and 3 companies listed in the U.S. Although investing in marijuana provides a significant amount of risk, this ETF provides a low-cost vehicle to invest in marijuana stocks, especially for the casual investor who does not devote much time to individual stock selection.

Notable Performers

Emerald Health Therapeutics Inc. (TSXV: EMH)

Emerald is a licensed cannabis producer under the Access to Cannabis for Medical Purposes Regulations (ACMRP) that sells both dried medial cannabis flower and oil in Canada through its wholly-owned subsidiary, Emerald Health Botanicals. The Company operates a facility in Victoria, BC.

In Q1/2017, the Company reported revenues of $201k, a 390% increase from the same period last year, yet Emerald managed to report a negative gross margin. Gross margins were negative due to low volumes and high fixed costs required to meet regulatory requirements. Production costs include security, quality control, and related overhead. Expected volume increases coupled with an expanded production facility should allow Emerald to benefit from economies of scale and attain positive gross margins.

Figure 1: Emerald Two-Year Financial Summary

	2017	2016		
	March 31 ($)	December 31 ($)	September 30 ($)	June 30 ($)
Revenue	201,268	124,251	48,933	38,729
Expenses	1,205,940	867,562	590,896	547,447
Share-based payments	201,186	137,113	467,878	37,618
Net Loss	(1,205,858)	(880,424)	(1,009,841)	(546,336)
Net Loss per share (basic and diluted)	(0.02)	(0.01)	(0.02)	(0.01)

	2016	2015		
	March 31 ($)	December 31 ($)	September 30 ($)	June 30 ($)
Revenue	41,408	23,902	7,389	-
Expenses	507,129	521,509	634,013	589,333
Share-based payments	38,179	37,751	90,406	876,420
Net Loss	(503,900)	(535,358)	(717,030)	(1,465,753)
Net Loss per share (basic and diluted)	(0.01)	(0.01)	(0.02)	(0.03)

Source: Company Filings

From February – April, 2017, the Company raised $37mm, which they intend to use to accelerate their facility expansion. The Company has been planning for expansion for a while now, as they state much of their R&D spending over their lifespan has focused on increasing plan diversity and product offerings, as well as improving its operational processes in anticipation of a significant scale up. This is a good sign as operational knowledge is essential when dealing with an expanded production facility.

In terms of the actual expansion, the Company plans to lease 32 acres of land in Metro Vancouver. The multi-phase expansion plan aims to increase production of cannabis and cannabis oil. In Phase 1, the Company plans to build a modular greenhouse growing facility with 50,000 sq. ft. of production space, and capacity of 5,000 kg per year, to be completed by Q1/2018. The Company expects to begin $20mm worth of construction, to be completed by the end of 2017. Phase 2 will add an additional 50,000 sq. ft. of production area, anticipated to begin shortly after the commencement of Phase 1, and will be ready for production in 2018. Emerald has the capacity to build out a total of 1mm sq. ft. of production space on the 32-acre property.

Figure 2: Emerald Expansion Plans

Source: Company Filings

The Company has also entered into a joint venture with Village Farms International, for large scale, high quality, low cost cannabis production. Village Farms has contributed a 20-acre greenhouse facility located in Delta, BC, which is estimated to yield 75,000 kg of product annually. Emerald will provide $20mm in cash and an additional $18mm upon completion of project milestones. Each party will have a 50% ownership stake in the JV.

Emerald is trading at 36x EV/NTM Sales, compared to the index average of 11.6x, suggesting the shares are overpriced.

Aurora Cannabis Inc. (TSXV: ACB)

Aurora is a licensed producer of medical cannabis under Canada's ACMPR. The Company operates a 55,200 sq. ft. facility in Mountain View County, Alberta, and is currently constructing two more facilities comprised of an aggregate 840,000 sq. ft. The Company is down 21% since our last report, likely due dilutive financing options taken in Q3/2017. Despite this, the Company has recently made two strategic investments, and is positioned for rapid growth upon completion of the Aurora Sky facility.

In Q3/2017, the Company increased revenues by 2,300% to $5.2mm due to an increased number of dried cannabis grams sold. Net income for the period was $139k compared to $2.5mm for the same period last year, however the income generated in Q1/2016 was due to an increase in the fair value of biological assets as opposed to fundamentally large sales and profitability in operations. The Company also saw an increase in EBITDA and operating cash flow, primarily due to the same reason mentioned above. All this is normal for a company in the early-growth stages, so it is likely not the reason for the decline in the stock price. Instead, investors were likely not happy about the dilutive financing options taken by the company. During Q3/2017, Aurora issued $40mm of convertible notes, and 160mm common shares, increasing the Company share count by 154%. The Company now has 344mm shares outstanding compared to 136mm at the end of June 30, 2016, so that $138k in net income the Company generated is not allocated to 208mm more shares, likely explaining the poor share performance. To learn about how Aurora may be further diluted, check our Warrant Watch report.

Figure 3: Aurora Financial Highlight

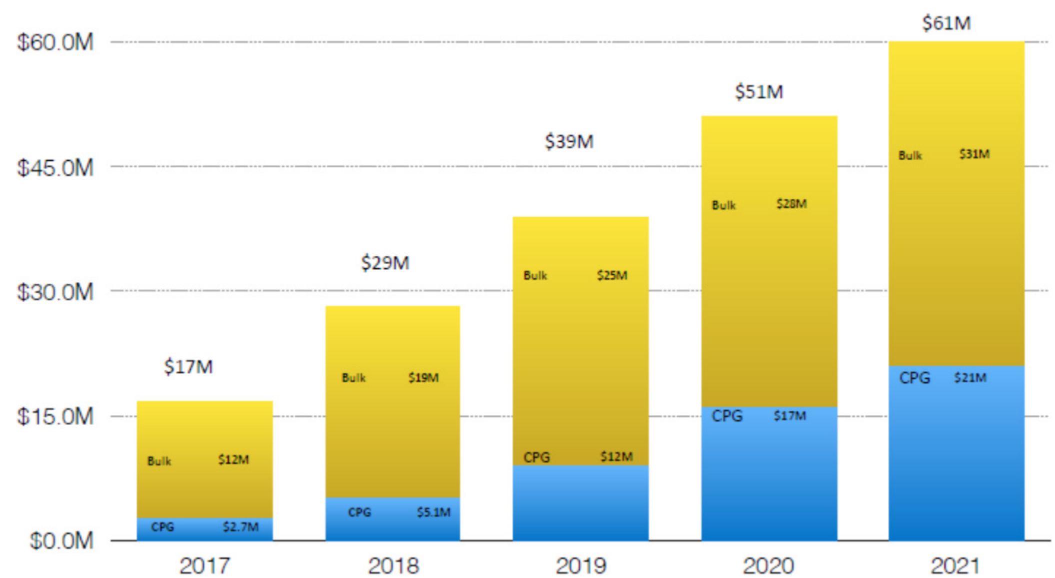
Financial and Operational Highlights

	Q3 2017	Q2 2017	Q1 2017	Q4 2016
	#	#	#	#
Active registered patients (cumulative) (1)	13,110	12,200	8,200	4,500
Grams sold	653,008	538,045	435,720	200,310
	$	$	$	$
Revenues	5,175,304	3,884,462	3,071,422	1,220,041
Adjusted gross profit (2)	3,142,464	1,479,838	1,348,546	(184,819)
Working capital	126,530,392	60,060,454	23,212,674	(2,751,400)
Investment in capital assets	10,464,414	4,157,709	645,101	278,414

Source: Company Filings

The money the Company raised, however, has been used to fuel growth. On June 8, 2017, Aurora agreed to purchase a 19.9% ownership stake in Hempco. Aurora is set to acquire 10.6mm units at $0.3075 per unit for a total of 3.2mm, with an option to bring the ownership stake to 50.1%. Hempco is a fast-growing industrial producer of hemp and hemp products. They currently are constructing a production facility that will double its capacity to ~225,000 kg per month, which is scalable to 600,000 kg per month. The Company expects to generate $61mm in revenue by 2021. Management plans to extract the cannabinol (CBD) from the industrial hemp and produce it at scale through their relationship with Radiant Technologies. There are currently regulations preventing industrial hemp producers from extracting CBDs, however these regulations are expected to be lifted.

Figure 4: Hempco Growth Projections



Source: Company Filings

Aurora made moves in their international expansion strategy when they acquired Pedanios GmbH on May 26, 2017 for $21mm. Pedanios is a wholesale importer, exporter, and distributor of medical marijuana in the European Union. They currently wholesale cannabis to 750 pharmacies in Europe. This acquisition gives Aurora exposure to the ~$14.6B European marijuana market.

Most of the funds the Company raised will be going towards the construction of the 800,000-sq. ft. Aurora Sky project, which is discussed in detail in our last edition. The Company states that construction is proceeding on schedule and that capital costs for the project will be in the range of $110mm. If the project is a success it will likely provide incremental earnings to investors that will outweigh the dilutive effect of their financing options.

Cronos Group Inc. (TSXV: MJN)

Cronos Group is a cannabis company that operates two wholly-owned Licensed Producers (LP) regulated within ACMRP, and holds a portfolio of minority investments in other LPs. The Company's two LPs, Peace Natural Projects, and In The Zone Produce Ltd., are collectively situated on over 125 acres of agricultural land and are currently licenses to produce 2,600 kg of cannabis on an annual basis. The Company's stock price is down 32% since our last report, likely due to a product recall on cannabis produced from its Peace Naturals Project.

The medical marijuana market is heavily regulated, and Health Canada requires all companies who participate in it to test for mould, heavy metals, harmful bacteria, and unauthorized pesticides. On May 4, 2017, Health Canada notified Cronos that it had found trace levels of Piperonyl Butoxide (PBO) upon testing a random cannabis leaf sample. Management states that the cause of this was due to cross-contamination from a sanitation protocol that is no longer practised at Peace. Under old management of the facility, the substance was used to clean the room between harvests. There is no evidence that PBO at this level can be harmful when ingested or inhaled, however, to be cautious the Company is in the process of assessing which lots have been impacted, notifying patients and voluntarily recalling any products that have potentially been impacted. Product recalls and the possible markdown of inventory due to tainted plants could lead to a down quarter for the Company.

Before the pesticide issue, operations appeared to be on track for the Company, as they generated $513k in revenue from Peace in Q3/2017, compared to $0 in the same period last year. Their investments in the Peace facility have seemingly paid off, as the production capacity is expected to increase to 5,000 kg of dried cannabis, and 6,000 litres of cannabis oil per year. Furthermore, in Q3/2017 In The Zone obtained a license to sell medical marijuana.

Figure 6: Peace Project Overview

Source: Company Filings

Bubble Radar

Trading multiples have compressed since our last report, as stocks in our index are now trading at 42.5x LTM sales compared to 52.6x in early March. As mentioned above, the multiple compression can be a result of numerous things. Although they have compressed, it cannot be ignored that an index average 42.5x sales multiple is extremely high, especially in an industry where many companies have not yet shown they can adequately run an efficient business, manage costs, and generate sustainable cash flows, let alone revenues.

The high multiples reflect the current hype surrounding the industry: many people are enticed by the large market projections, and the growth potential of existing stocks in the industry. This, however, makes for extremely risky investments, for instance, there are currently 50 LPs in Canada, with 42 of them being publicly listed. The size of the industry is projected to be $23 billion annually, if shared equally amongst everybody in the industry, this equals $460mm in revenue per company. Then one must factor in that more players will surely enter the industry to take a slice of the pie, especially given the Canadian government intends to ease the approval process for pot producers, further shrinking the profits attributable to each individual company. This makes it difficult to select an individual security, especially given their high valuations.

Important Disclosure

Smallcappower.com is owned and operated by Ubika Corporation whose divisions include Ubika Research and Ubika Communications. Ubika Corp. is a wholly owned subsidiary of Gravitas Financial Inc. The following terms and conditions ("Terms of Use") govern the use of this website ("site") www.SmallCapPower.com. By accessing this site, you agree to comply with and be legally bound by the Terms of Use as set out herein. Ubika reserves the right to seek all remedies available at law and in equity for violations of these Terms of Use, including the right to block access from a particular internet address to our site.

Disclaimer

Ubika Corporation and its affiliates or partners will seek to provide services to companies mentioned on the smallcappower.com website. Hence, all information available on smallcappower.com should be considered as commercial advertisement and not an endorsement, offer or recommendation to buy or sell securities. Ubika Corporation and its related companies (including its directors, employees and representatives) or a connected person may have ownership/stock positions in, or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time.

Ubika and/or its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities and/or commodities and/or commodity futures contracts in certain underlying companies mentioned in this site and which may also be clients of Ubika's affiliates. In such instances, Ubika and/or its affiliates and/or their respective officers, directors or employees will use all reasonable efforts to avoid engaging in activities that would lead to conflicts of interest and Ubika and/or its affiliates will use all reasonable efforts to comply with conflicts of interest disclosures and regulations to minimize the conflict.

Specifically all companies mentioned or listed as "Analyst Covered Companies" at smallcappower.com and which are shown under the heading "Analyst Covered Companies" on the page: http://www.smallcappower.com/companies have entered into a commercial relationship with Ubika Corporation or our affiliates for capital market services and have paid fees and/or shares or stock options or warrants for being featured and mentioned in smallcappower.com. Hence these "Analyst Covered Companies" at smallcappower.com are shown at the website as an advertisement only and any mention of these companies does not and will not constitute an offer to buy or sell securities in the featured companies. Ubika Corporation, its affiliates or partners will seek to provide services to companies mentioned in smallcappower.com website. Hence, all information available on smallcappower.com should be considered as commercial advertisement and not an endorsement, offer or recommendation to buy or sell securities.

Ubika Corporation and its divisions Ubika Communication and Ubika Research (collectively, "Ubika") are not registered with any financial or securities regulatory authority in Ontario or Canada, and do not provide nor claims to provide investment advice or recommendations to any visitor of this site or readers of any content on this site.

The information on this site is for informational purposes only. This site, including the data, information, research reports, press releases, findings, comments, views and opinions of Ubika's analysts, columnists, speakers or commentators, and other contents contained in it, is not intended to be: investment, tax, banking, accounting, legal, financial or other professional or expert advice of Ubika or its affiliates, or a recommendation, solicitation or offer by Ubika or its affiliates to buy or sell any securities, futures, options or other financial instruments, and such information should not be relied upon for such advice. Every user of this site is advised to seek professional advice before acting or omitting to act on any information contained in the site.

Research reports and newsletters have been prepared without reference to any particular user's investment requirements or financial situation. Where reference is made to estimate of value or relative value of a specific company, there is no guarantee that these estimates are reliable or will materialize. Readers of these reports and newsletters are advised to conduct their own due diligence before making any investment decisions. Ubika does not make independent investigation or inquiry as to the accuracy and completeness of any information provided by the Analyst Covered companies. Although the content has been obtained from sources believed to be reliable, this website could include technical or other inaccuracies or typographical errors and it is provided to you on an "as is" basis without warranties or representations of any kind. Ubika and its affiliates make no representation and disclaim all express and implied warranties and conditions of any kind, including without limitation, representations, warranties or conditions regarding accuracy, timeliness, completeness, non-infringement, satisfactory quality, merchantability, merchantable quality or fitness for any particular purpose or those arising by law, statute, usage of trade, or course of dealing. Ubika and its affiliates assume no responsibility to you or any third party for the consequences of any errors or omissions.

Information in this site is subject to change without notice. Ubika assumes no liability for any inaccurate, delayed or incomplete information, nor for any actions taken in reliance thereon.

Ubika, its affiliates and their respective directors, officers, employees, or agents expressly disclaim any liability for losses or damages, whether direct, indirect, special, or consequential, or other consequences, howsoever caused, arising out of any use or reproduction of this site or any decision made or action taken in reliance upon the content of this site, whether authorized or not. By accessing this site, each user of this site releases Ubika, its affiliates and their respective officers, directors, agents and employees from all claims and proceedings for such losses, damages or consequences.

Ubika and its affiliates do not endorse or recommend any securities issued by any companies identified on, or linked through, this site. Please seek professional advice to evaluate specific securities or other content on this site. Links, if any, to third party sites are for informational purposes only and not for trading purposes.Ubika and its affiliates have not prepared, reviewed or updated any content on third party sites and assume no responsibility for the information posted on them.

Ubika and/or its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities and/or commodities and/or commodity futures contracts mentioned in this site.

This site may include forward-looking statements about objectives, strategies and expected financial results of companies featured in this site or where research reports are available on companies displayed and/or featured on this site. Such forward-looking statements are inherently subject to uncertainties beyond the control of such companies. The users of this site are cautioned that the company's actual performance could differ materially from such forward-looking statements.

World Wide Web sites accessed by hypertext links ("hyperlinks") appearing in this site have been independently developed by parties other than Ubika and Ubika has no control over information in any hyperlinked site. Ubika is providing hyperlinks to users of this site only as a convenience. Ubika makes no representation and is not responsible for the quality, content or reliability of any information in any hyperlinked site. The inclusion of any hyperlink in this site should not be construed as an endorsement by Ubika of the information in such hyperlinked site and does not imply that Ubika has investigated, verified or monitored the information in any such hyperlinked site. Should you wish to inquire about creating a link from your World Wide Web site to this site, contact SCP marketing via e-mail at: info@smallcappower.com. for written authorization.

See our full disclaimer here.