

A NEW INDUSTRY: THE ESSENTIALS OF THE CANNABIS BUSINESS

The legalization of recreational cannabis in Canada represents a rare event: a new industry being created by ending prohibition. This burgeoning industry presents opportunities for both businesses and investors. However, to properly capitalize on the opportunities, those involved must be armed with the right knowledge to navigate the rapidly changing landscape.

This primer aims to provide a basic overview of the cannabis industry, including key terminology, the market and participants, regulatory issues and investment options.

KEY TERMS

CANNABINOIDS The class of chemical compounds that includes the primary components found in marijuana. Cannabinoids act on receptors in the brain, altering the release of neurotransmitters to produce psychoactive and therapeutic effects.

THC (Tetrahydrocannabinol) The primary psychoactive chemical compound in marijuana, responsible for producing a euphoric high.

CBD (Cannabidiol) The primary non-psychoactive chemical compound in marijuana, believed to be responsible for alleviating anxiety and other therapeutic effects.

EDIBLES Any food or beverage that contains THC, CBD or a combination of both. Due to the way the body metabolizes the chemicals in the stomach, the effects appear more slowly and can last much longer than they would if inhaled.

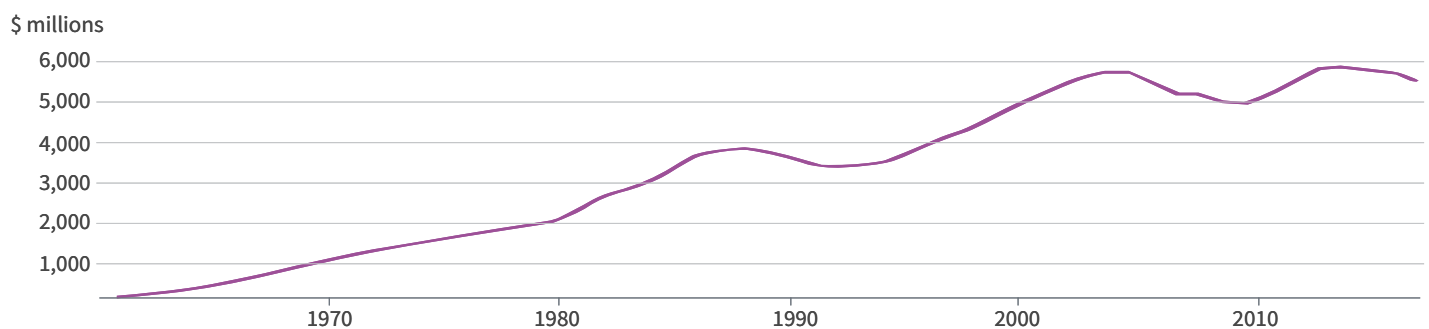
CONCENTRATES A wide variety of products that contain extracted and concentrated versions of cannabinoids. This includes oils, waxes and other forms of the extracted chemicals which may be used to create edibles or other types of infusions for consumption.

THE MARKET

The size of the cannabis market in Canada is in the billions of dollars. However, precise measurements are difficult in the absence of reliable statistical data. The true scope of the market should become much clearer in the years following legalization.

Various estimates and analyses suggest the total market falls roughly between the \$5- and \$7-billion range. Statistics Canada estimates the household consumption expenditure on cannabis reached \$5.5-billion in 2017. A Deloitte analysis expects total sales in 2019, including medical, illegal and legal recreational products, will reach up to \$7.1-billion².

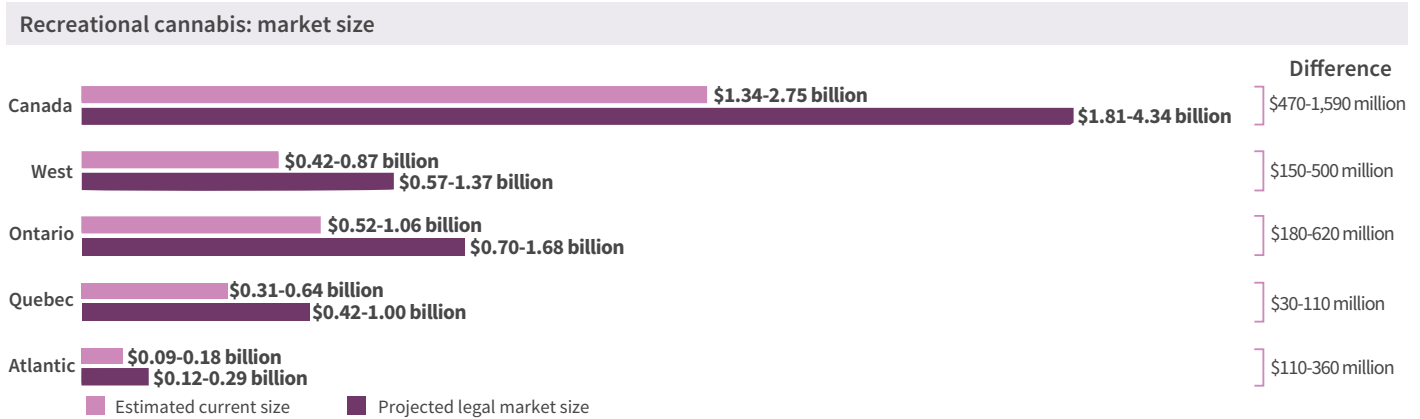
Expenditure: total, 15 years and over 2017



Source: Statistics Canada, Cannabis Stats Hub <https://www150.statcan.gc.ca/n1/pub/13-610-x/cannabis-eng.htm>

Difficulty in estimating the size of the market stems from the inability to accurately gauge the impact of the illegal marijuana trade. It is likely that issues surrounding precise data collection will continue after legalization, given that less than two-thirds of regular pre-legalization users plan to move their purchases to legal channels. However, this does suggest legalization will be successful in drastically reducing the size of the illicit market, thus making the data more reliable in the future.

Deloitte predicts that legal sales will constitute more than half of the total cannabis market in the first full year of legalization, and that the bulk of any growth in the market will come from older, educated and more conservative consumers³. It is worthwhile to note that total marijuana sales in Colorado more than doubled between 2014, the first year of legalized cannabis, and 2017 to more than US\$1.5-billion, with millions of tourists contributing to the cannabis economy⁴.



Source: Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

CONSUMERS

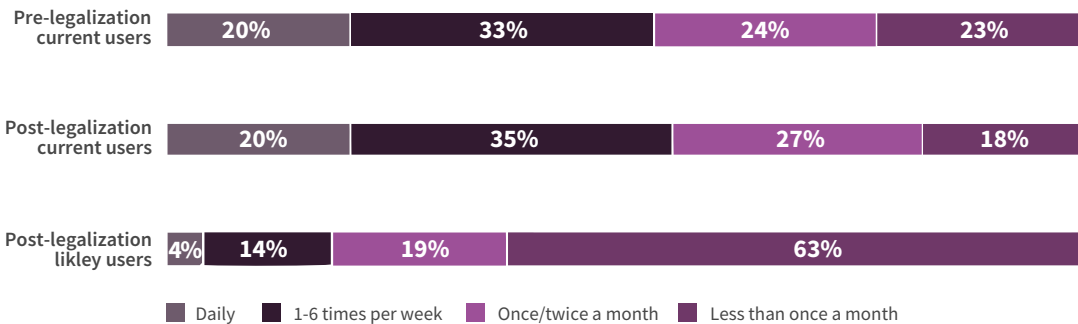
The consumer base can be split into two groups: current users and likely users after legalization. Surveys suggest the two groups have quite different demographics⁵.

| CURRENT USER | LIKELY USER |
|--|--|
| More likely aged 18-34 | More likely aged 35-54 |
| More likely to consume multiple times per week | More likely to consume less than once a month |
| More likely to have a high school or college education | More likely to have a university or graduate school education |
| More likely to take health and safety risks | More likely to prioritize family interests ahead of personal interests |

Source: Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

Research also indicates that consumption levels are unlikely to change radically after legalization. The only notable change amongst current users can be seen in those who report consuming less than once a month moving slightly into higher-frequency categories, but not towards daily use⁶. These expectations are in-line with the experience of Colorado, where overall usage rates remained stable in the first two years after legalization⁷.

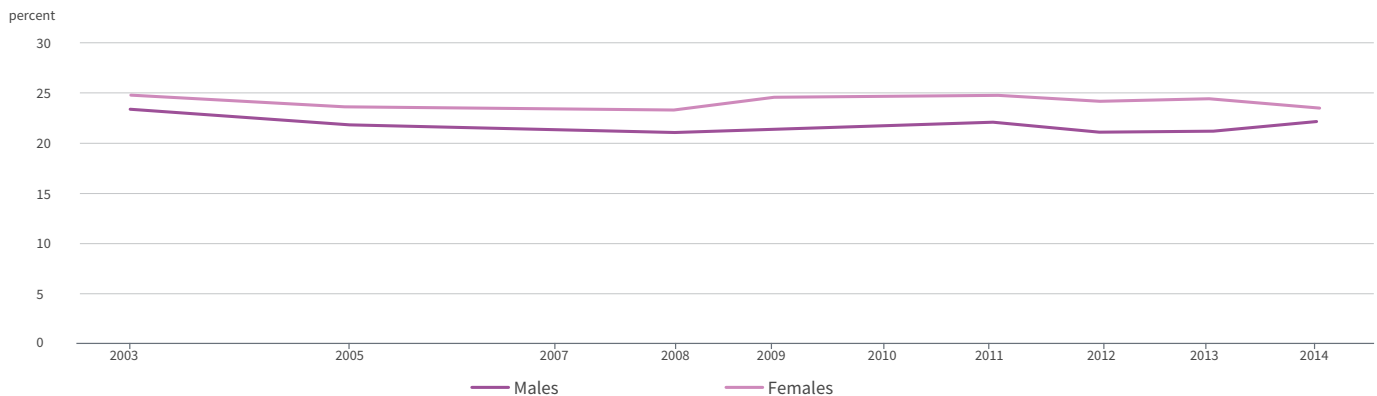
Consumption behaviour: frequency of use



Source: Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

An important component to expectations of relatively unchanged consumption patterns may be found in the reported motivations for consuming recreational cannabis. Nearly two-thirds of current users say they consume cannabis to help relax, sleep and reduce stress⁸. Women are more likely to consume cannabis for relaxation and stress relief for these reasons, which is in line with higher percentages of women reporting that most days are “quite a bit” or “extremely stressful.”⁹ Opening legal distribution channels will give those seeking relaxation and stress relief easier access to cannabis, but there is little evidence to suggest greater access alone will lead to increased consumption.

Percentage reporting most days “quite a bit” or “extremely stressful”: 15 years and older, 2003 to 2014



Source: Statistics Canada, Perceived life stress, 2014 <https://www150.statcan.gc.ca/n1/pub/82-625-x/2015001/article/14188-eng.htm>

Transitioning users to legal challenges will be key for curbing the illegal market. Not surprisingly, current users are much more likely to continue purchasing cannabis on the illegal market than likely users are. They’re also much more likely to grow their own cannabis, a legal option in many provinces and territories¹⁰. Businesses will have to stay in-line with consumer demands to foster the transition to legal sales.

Current and likely cannabis users have similar considerations when it comes to making purchasing decisions around marijuana. Both place pricing at the highest priority when deciding on a product. Safety concerns, reputation, and type of product (plant material, edibles, etc.) all are among the top concerns. While familiar brand and preferred packaging are uniformly less important to both consumer groups¹¹.

REGULATORY RIPPLES

PROVINCIAL DIFFERENCES

The use of recreational cannabis will be legal across Canada. However, similar to the treatment of alcohol, provinces will have the ability to regulate various aspects of cannabis use, including minimum legal age, consumption restrictions, growing at home and distribution. All of these differences will have some impact on the market and business opportunities within each jurisdiction.

| | ON | QC | BC | AB | NL | NWT |
|--------------------------|-------------------------------------|--------------------------------|---|--------------------------|--------------------------------------|--------------------------------------|
| Minimum age | 19 | 18 | 19 | 18 | 19 | 19 |
| Consumption restrictions | Same as tobacco, except in vehicles | No public consumption allowed | Same as tobacco, except in vehicles and near children | Same as tobacco | In private dwellings/on private land | In private dwellings/on private land |
| Permitted retailers | Private in April 2019 | Société québécoise du cannabis | Private and public; producers not allowed to retail | Private | Private | NWT Liquor Commission |
| Online sales | Public | Public | Public | Public | Public to start | Public |
| Home growing | Will follow Cannabis Act | Not allowed | Allowed | Will follow Cannabis Act | Will follow Cannabis Act | Will follow Cannabis Act |

Source: Provincial governments, selected to show difference in regulation

STILL TO COME: EDIBLES AND CONCENTRATES

While the use of recreational cannabis will be legalized as of October 17, 2018, refined products will remain restricted for up to a full year. The federal government has committed to regulating edibles, concentrates and other derivative products within a year of legalization. This represents perhaps the greatest opportunity for growth in the cannabis industry.

Cannabis is typically consumed through inhalation, either through smoking or vaporization, which reduces the amount of particulate material that enters the lungs. However, improved education about the health affects of smoking has created a social taboo around it. Edibles and concentrates may become the most popular cannabis products among those with a strong aversion to smoking.

Surveys suggest there is a strong appetite for non-smokable cannabis products. More than half of current and likely consumers say they are interested in trying cannabis-infused baked goods while 43% are interested in trying cannabis-infused chocolate. Indeed, there is broad interest in a wide range of cannabis-infused products, including candies, beverages, popsicles and even crackers¹².

INVESTING IN CANNABIS

The Canadian cannabis sector has grown rapidly in the last few years as investors are eager to participate in a brand-new industry with unique opportunities. In 2017, the market capitalization for the five largest cannabis stocks grew by 400%¹³. Through the first half of 2018, more than \$1.3-billion in assets under management flowed in to cannabis-focused exchange-traded funds or other investment funds. Investors are embracing the cannabis space, however, as a burgeoning sector it poses unique challenges relative to older, more established industries.

STOCKS

There is a relatively large number of cannabis stocks available on Canadian stock exchanges and the subsector as a whole has caught the attention of investors and the media. Some individual stocks have seen rapid and sharp movements and the subsector broadly has been highly volatile. Many investment professionals believe the subsector has experienced periods of speculative mania, given that the way companies will be analyzed post-legalization will change once investors can get a better grasp on company financial reports and fundamentals.

Further complicating the analysis of individual companies is the wide scope of businesses operating within the industry. A large number of the companies involved in the cannabis industry are licensed producers which grow the plant material. A smaller number of companies are involved in developing refined cannabis products, including concentrates and edibles, while others are focused on pharmaceutical applications. Some of the larger companies are more diversified in their business, operating multiple units related to the marijuana industry.

In a youthful and evolving space such as cannabis, the performance of individual stocks will vary greatly as businesses compete and discover the most successful business models. While legalization will eventually lead to more clarity regarding which companies will succeed, the subsector as a whole will likely continue to experience volatility as it matures.

Valuations and volatility



Source: Echelon Wealth Partners

EXCHANGE-TRADED FUNDS (ETFs) AND MUTUAL FUNDS

ETFs and mutual funds have become popular vehicles for investing in the cannabis space. They typically offer investors lower concentration risk by holding a basket of cannabis and cannabis-related stocks. These funds also allow investors to focus on more thematic elements such as junior growers, similar to a fund that invests in small companies in the mining sector.

Many cannabis funds invest passively by mirroring indices which track marijuana-related companies. This style of investing can pose its own set of risks in a young and rapidly moving subsector. Cannabis stocks have moved largely in unison with one another as there has been little in terms of fundamental analysis to distinguish the highest-quality companies. However, as the industry grows, it will become more apparent which companies will be successful and which will not, and their stock prices will be more likely to reflect the strengths or weaknesses of the underlying businesses. Passive funds will capture both the good and the bad, and thus are more of a play on the subsector as a whole.

Active funds, on the other hand, seek to profit from the best opportunities while avoiding losses from the lowest-quality companies. Successful active investing requires an experienced manager who can properly identify the companies with the highest-likelihood of generating returns and the discipline to lock-in profits rather than chase greater returns. In addition to navigating the volatility in the space, actively managed funds can also provide access to initial public offerings which are typically inaccessible to retail investors and utilize more advanced risk-management tools.

¹ Statistics Canada, Cannabis Stats Hub <https://www150.statcan.gc.ca/n1/pub/13-610-x/cannabis-eng.htm>

^{2,3} Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

⁴ Colorado Department of Revenue, Marijuana Sales Reports <https://www.colorado.gov/pacific/revenue/colorado-marijuana-sales-reports>

^{5,6} Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

⁷ US National Survey on Drug Use and Health, Comparison of 2014-2015 and 2015-2016 Population Percentages <https://www.samhsa.gov/data/sites/default/files/NSDUHsaeShortTermCHG2016/NSDUHsaeShortTermCHG2016.htm>

⁸ Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

⁹ Statistics Canada, Perceived life stress, 2014 <https://www150.statcan.gc.ca/n1/pub/82-625-x/2015001/article/14188-eng.htm>

^{10, 11, 12} Deloitte, 2018 cannabis study <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>

¹³ Bloomberg L.P.

¹⁴ Echelon Wealth Partners

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