

Cannabis

Over the past year, several clients have approached me about investing in the cannabis industry (or as our Bloomberg terminal amusingly classifies it, “specialty pharmaceuticals”). In those conversations, I have pointed out that simply because a new idea or industry is revolutionary and appears to have phenomenal growth opportunities does not mean it is a good investment (the automotive and airline industries are two good historical examples). Further, even if you pick the right industry it doesn’t automatically mean you will pick the right stocks within that industry, which is just as important.

Cannabis stocks have flamed out this year

By Paul R. La Monica

October 8, 2019

New York (CNN Business) This was the year when cannabis stocks were supposed to take off.

But shares of all the major pot stocks are down, despite hype about the legalization of recreational marijuana in Canada and some US states. The signing of the Farm Bill by President Trump last fall, which had the potential to boost CBD/hemp sales, hasn't helped as much as investors hoped.

Cronos Group (CRON) and Canopy Growth (CGC) have plunged more than 60% from their highs earlier this year, and are down about 15% for 2019. The drop in value has hurt the performance of two leading consumer products companies that back them.

Struggling Marlboro owner Altria (MO) has a nearly 45% stake in Cronos, while Corona parent company Constellation Brands (STZ) recently announced it was taking a more than \$800 million writedown on its investment in Canopy.

That's clearly not sitting well with Constellation. Canopy co-CEO Bruce Linton was forced out a few months ago after Constellation CEO Bill Newlands said he was "not pleased" with the company's results.

Those aren't the only cannabis stocks that are struggling.

Shares of Aphria (APHA) have fallen nearly 10%. Aurora Cannabis (ACB), which has activist investor Nelson Peltz as a strategic adviser, is also down 15% this year.

And Tilray (TLRY), a cannabis company whose majority owner is Privateer Holdings, the investment firm backed by Peter Thiel's Founders Fund, has plummeted 66%.

Investors had hoped that the passage of the SAFE Banking Act in the House at the end of last month would give the stocks a significant boost. The bill, which would make it easier for financial institutions to provide banking services in states where legal cannabis businesses operate, still has to pass in the GOP-controlled Senate -- and that's not a sure thing.

Fundamentals matter -- even for cannabis stocks

What will it take for the sector to bounce back?

Profits would be nice. Nearly all the major cannabis companies continue to lose lots of money.

George McBride, CEO of Hanway Associates, a London-based consulting firm specializing in cannabis research, said there are still promising opportunities in the business of recreational and medical cannabis. Companies just have to prove that they are not a flash in the pan.

"The early movers in cannabis that listed their stocks a few years ago did so at a fortuitous time and were able to raise a lot of money astronomically fast. But they grew very quickly and now sales have not matched investor expectations," said McBride, who is also co-founder of the Cannabis Europa events conference organization.

In a sense, the cannabis companies are suffering from the same problems that Uber (UBER), Lyft (LYFT), Slack (WORK) and many other ballyhooed startups that recently went public.

"The sell-off in cannabis is part of a wider trend. Investors have moved away from other unicorns because they want earnings, not just market share. Investors haven't demonstrated that much patience," McBride said.

Matt Markiewicz, managing director of Innovation Shares, which runs The Cannabis ETF ([THCX](#)), agreed that investors got too excited about the short-term outlook for the sector.

"Exuberance around Canada legalizing adult recreational usage was pretty high. Analyst expectations for sales and consumption were very bullish and it just did not materialize," Markiewicz said.

Lower prices hurting companies that sell to consumers

The increased competition has also pushed prices for recreational cannabis lower, which has dampened the revenue outlook for many of the leading players.

BDS Analytics, a research firm that tracks cannabis prices, said in a recent report that consumer prices for cannabis-related products in the US in August fell nearly 3% from a year ago.

That's a big reason why experts say investors who want to bet on cannabis, CBD or hemp should look beyond the companies that sell products to consumers, which have the most exposure to lower prices.

Sam Masucci, CEO of ETF Managers Group, which runs the ETFMG Alternative Harvest ETF ([MJ](#)), ... says the broader reaction in the industry may be a bit overdone. Some leading cannabis companies have probably been oversold, since it's unreasonable to expect profits from companies selling recreational cannabis just yet.

"The sector is very volatile and that's to be expected given the nascence of the business. It's still a new market," Masucci said, adding that investors may also be overreacting to concerns that a possible crackdown on vaping could hurt cannabis companies.

There have been reports of some people getting sick from vaping synthetic, illegal marijuana. But Masucci said that's all the more reason for states to have stricter rules for legal cannabis products.

Some bargains in the pot stock rubble

Markiewicz also thinks the sell-off has overly punished companies like Aurora and Canopy, which have a greater presence in markets outside of Canada and the US -- most notably Europe. His ETF owns both stocks.

He added that there are also good opportunities in smaller Canadian companies that work with cannabis firms
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Still, the shakeout for publicly traded cannabis companies was probably overdue.

"The large public cannabis companies were overvalued. This is a come-back-to-Earth rationalization," said Matt Hawkins, co-founder and managing principal of Entourage Effect Capital, a cannabis-focused private equity firm. ...

From Meb Faber:

The Cannabis Opportunity

July 19, 2019

Would you like to go back in time and invest in beer companies when the United States ended Prohibition in 1933? You bet – the stocks returned 20% per year in the decade following legalization, nearly double the returns of the overall market. There is a similar situation developing around the globe currently as legal restrictions on cannabis production and consumption are being lifted.

Unless you've been avoiding the financial media over the past few years, you're aware of some of the extraordinary gains that have been made through investing in select cannabis-related stocks.

For example, take Canopy Growth (CGC), the largest cannabis company in the world. Canopy went public in 2014. Since that time, it has proved to be one of the market's strongest performers.

During early 2014, Canopy was valued at just \$20 million. As I write, the stock has been a multi-bagger valued at \$12 billion. ...

And as to its price gains, it's gone from its IPO price of \$2 per share, down to trading just above \$1 per share, to nearly \$35 per share as I write.

Other stocks, like Tilray have seen similar explosive moves, both up and down. Starting from an IPO price of \$22 to a peak of \$214, the stock has retraced all the way back to \$43 for a drawdown of around 80% and counting. Ouch!

Behind this growth and market volatility is a tectonic shift in the global public's view toward cannabis, resulting in major legislative reform that's paving the way toward full legalization in countries around the globe. As this legalization continues to spread, researchers suggest it could result in a massive new industry with annual global revenues potentially hitting hundreds of billions if not over a trillion dollars.

The Cannabis Theme

At this point, let's digress for a moment in order to discuss "thematic" investing, which is the category under which a cannabis investment would fall.

... the best performing stock industry of all time is likely tobacco stocks, but many investors avoid them for moral reasons. Ethics aside, the structural (in this case, "behavioral") element of an addictive product resulted in major long-term outperformance for the tobacco theme. ...

Today, we believe there is an equally compelling opportunity setting up in the theme of cannabis stocks. To be clear, we view this as more of an opportunistic investment – a portfolio “tack-on” while the conditions are favorable. Of course, this opportunity and its favorable conditions may be with us for many years – such as tobacco.

We see cannabis investing as falling under the structural (or behavioral) category of reasons to own a thematic fund. There is still social stigma surrounding the industry, but also very real structural impediments from people even investing in the space. In many cases, you literally cannot even buy these securities even if you wanted to...and to be clear, many don't want to. (We've had a cannabis fund filed for over two years but never had a custodian willing to hold the stocks, despite the stocks being exchange traded!)

But that's also presenting an opportunity.

In this short piece, we're going to recap some of the highlights as to how we arrived at this point, look at the state of the market today, then spell out the potential opportunities available to those investors interested in being a part of this explosive growth.

How We're Gotten Here

We're experiencing a historic boom in the legalized cannabis investment sector. We can trace its origins back to 1996, when California voters approved Proposition 215, the first legislation legalizing cannabis for medical purposes at the state level.

Since then, cannabis legalization on the state level has grown, and has been intensifying in recent quarters. As I write, recreational cannabis is now legal in 11 states, with medical cannabis being legal in 33 states. This is hardly a surprise, as a [2018 poll from Pew Research](#) reveals that most of Americans now support legalizing cannabis.

Related cannabis-legalization victories have also come in recent months, with one significant victory being the passing of the 2018 Farm Bill. This historic legislation legalized hemp. For decades, hemp was classified as a controlled substance under federal law, despite having no psychoactive effect. The bill's passing has opened the door to explosive growth in the hemp-sourced CBD market. Additionally, Canada's legalization of recreational cannabis in 2018 was a huge domino to fall as the zeitgeist continued to embrace this shift in attitude toward cannabis.

Despite these advancements, at present, cannabis is still illegal on the federal level in the United States.

That said, we're seeing significant pressure for meaningful cannabis legislative reform. For example, there's the STATES Act (Strengthening the Tenth Amendment Through Entrusting States), currently making its way through Congress. Its passing would give individual states the ability to make their own laws about cannabis legalization without federal interference. There's also the SAFE Banking Act (Secure and Fair Enforcement Banking Act). It would enable banks and traditional financial institutions to service cannabis companies without fear of federal repercussions. Additionally, as I write, nearly every democratic 2020 presidential candidate has come out in favor of cannabis reform.

This groundswell of support points toward a clear takeaway: the legalized cannabis industry is not a short-lived fad, and offers the potential for significant gains as the industry evolves in the coming years – especially after the U.S. government either legalizes cannabis, or passes the STATES Act, which will free users and businesses from fear of repercussions when engaging in cannabis use.

So, what sort of gains are analysts suggesting?

What Analysts Are Saying About Industry Growth

According to CB1 Capital, the global market for cannabis and hemp was roughly \$300 billion in 2018. ... Looking forward, when factoring in cannabis and hemp in a wider array of end products and use-cases, the global market cap for cannabis-related companies is predicted to reach \$1 trillion within a decade. (For perspective, global alcohol sales are about \$1.5 trillion, versus global box office sales of around \$50 billion).

Most of the global demand for cannabis is still being met on the black market. But that also means there is a vast customer base just waiting to be tapped. At the time of this writing, a recent [Barclays report](#) estimates that the size of the legal U.S. cannabis market is around \$28 billion, climbing to \$41 billion by 2028.

And it's growing fast. Here in the United States, [estimates peg the compound annual growth](#) rate of the legal cannabis market at over 30% growth through 2025.

Unlike short-lived investment fads, cannabis's growth is just starting to be fueled by major corporate investment and institutional investors. For example, Constellation Brands (owner of alcoholic beverage brands such as Corona), has taken a 35% stake in Canopy Growth, a Canadian cannabis company mentioned earlier, which recently announced plans to buy the American cannabis group, Acreage Holdings. There's also cigarette company, Altria, which has a \$1.8 billion stake in cannabis producer, Cronos Group. Then there's Budweiser, working on cannabis-infused drinks with cannabis company, Tilray. Meanwhile in the institutional investment space, we have the largest pension in the United States, CalPERS, owning a stake in cannabis company, Tilray.

The Investment Market Today

At the time of this writing, the cannabis investment market is disorganized, as any emerging sector would be. An investor looking to put money to work could focus on the cannabis growers, the full-service retailers dealing direct to consumers ("seed to store"), the companies focusing on the medicinal benefits of cannabis (for example, Epidiolex or Charlotte's Web), companies focusing on CBD-infused products, or even companies offering infrastructure plays, such as the cannabis REIT, Innovative Industrial, among many other options.

Also characterizing this early stage of development is a great deal of consolidation as market share dominance remains up for grabs. In recent weeks, we've seen a string of consolidations – Canada's Canopy Growth buying the American company, Acreage Holdings, and Curaleaf's purchase of Cura Partners and Grassroots Inc, to create the world's biggest cannabis company by revenue. There's also been Cresco Labs intent to buy cannabis distributor Origin House, and Harvest Health & Recreation Inc acquiring Verano Holdings.

Yet this pivot toward cannabis isn't just a North American phenomenon.

As mentioned earlier, cannabis is now legal in Canada. And as I write, Luxembourg is poised to become the first European country to legalize cannabis for recreational use. But what you may not know is that cannabis is either legal, decriminalized, or socially accepted in [26 countries](#) around the globe.

This is truly a global movement, which bodes well for cannabis as a long-term, substantive investment market. There will eventually be expansion into two of the largest continental markets, Asia and Africa as well.

Looking Forward

It's an exciting time to be an investor considering the cannabis sector.

One of the factors behind this massive investment growth is the realization that the majority of cannabis sales are still happening on the black market – in other words, despite the gains to date, the overwhelming majority of growth is still in front of us.

But as cannabis reform legislation continues to be enacted on the state level, and eventually the U.S. federal level, it makes sense to assume that this massive market share would rotate toward legal sales channels – meaning huge revenue growth for legal cannabis’s market leaders. And as the legal sales channels proliferate and new cannabis products are offered, new users will be willing to try cannabis, which will vastly expand the total addressable market of this industry.

It’s this opportunity that has cannabis investors excited about the coming decade. Imagine investing in the alcohol industry after Prohibition ended.

The reality is that the investment opportunity in front of us is a rarity. Cannabis already has an enormous and loyal consumer base. Yet, anti-cannabis laws around the globe have muted cannabis’s free-market supply/demand dynamic. And it’s only now that meaningful reform legislation is beginning to be enacted that we’re seeing what’s possible in terms of demand and market size. As an analogy, it almost feels as though we’re witnessing a massive dam being removed, making way for the flood that’s been long pent up.

Given this, as laws change, we anticipate the legalized cannabis industry will experience growth that vastly outpaces rates from developed, mature industries. That means investors today have the chance to make responsible “bets” on this emerging industry, potentially being rewarded by outsized returns.

That said, like any nascent investment industry, caution is required as there will be losing investments alongside the winning investments. ... And just because there is growth tailwinds doesn’t mean an investor can be price agnostic, a lesson everyone learned (or should have!) a few times in the past 20 years.

Plus, there’s no certainty that today’s market share leaders will translate into tomorrow’s winning investments. For this reason, it makes sense to be diversified with broad exposure to the overall sector.

But the basic thesis for the opportunity remains. There are structural reasons many funds and investors will never invest in cannabis securities. And with stocks having a current global market cap of less than \$100 billion, there is plenty of room for multi-bagger growth potential in the sector. ...

Our thoughts

Each month I screen International Markets for Quest Opportunity Fund. The result this month was the purchase of Canada's Supreme Cannabis (**FIRE.TO**), an IVA System pick:



Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
08/06/2019	1	Chan Steve		21,700
08/01/2019	1	Moore Colin		20,000
07/24/2019	1	McKinnon Kenneth R		60,000
07/19/2019	2	Handa Nikhil, Dhaliwal Nave		225,000

Most cannabis stocks are traded outside the US (as cannabis still isn't legal federally), so cannot be accessed by HCM clients. However, that does not mean we aren't looking for opportunities. The stock above was the first cannabis stock I've found that meets our valuation criteria. In an industry with as much political risk as well as investor excitement driving up valuations, it is very important to stick with time-tested valuation metrics and insider buying. Jumping into the latest fad regardless of how promising it may appear is a recipe for getting burned.