

# Market Update

## Cannabis in Canada

November 1, 2018

**The recent legalization of cannabis consumption in Canada has brought with it a wave of questions about the new industry, including its effect on the economy. In addition, the listing of a number of new companies in the industry has captured the attention of investors.**

In terms of the economic implications, it's important to bear in mind that the market is not growing from zero – there exists already a substantial black market for cannabis that will presumably shrink somewhat as legalization goes into effect. While untaxed and imperfectly captured in official economic statistics, this black market decline tempers the net economic boost of cannabis legalization. Providing an estimate of the economic impact of legalization, the Parliamentary Budget Office projects total annual revenues of less than CAD\$10 billion per year from legal and illegal purchases combined; for context, this represents less than half a percentage point of Canadian GDP. Considering that a large fraction of these total revenues would already have been generated (albeit via illegal channels), that some of the additional money is merely reallocated within the consumer budget rather than brand new, and that much of this revenue would presumably be eaten up by expenses, the net annual economic boost is theoretically well below CAD\$1 billion per year, adding just a few hundredths of one percent to GDP. In short, Canada's new industry is an economic positive, but not a huge one.

The financial market implications of legalization are potentially greater than the economic ones, for three reasons. First, company valuations are forward-looking, meaning the stock market can look past current paltry figures and toward the future profits that may come once the industry has hit its stride. Furthermore, the value of a stock is usually many times its expected annual earnings, allowing for much higher company market capitalization than annual economic activity. Second, because formal businesses have historically had close to zero involvement in the cannabis industry, there is room for them to pick up a large fraction of the market as they crowd out illegal producers. Third, to the extent that Canada finds itself among the first movers on cannabis legalization, Canadian companies could benefit disproportionately by gaining a foothold in foreign markets if/when liberalization happens elsewhere.

Until recently, cannabis stocks had been among the strongest in the Canadian equity market over the past few years. There are currently three marijuana companies included in the S&P/TSX Capped Composite Index; collectively, they account for 1.25% of the index as of September 30th. There is also a large number of smaller cannabis

**Performance of Marijuana Stocks in the S&P/TSX**



Source: Factset



companies listed on the Toronto Stock Exchange as well as other exchanges. An ETF created to track this nascent sector comprises a total of 62 constituent companies and assets of over CAD\$700 million as of the end of October. Within the S&P/TSX, the performance of these companies made the Health Care sector in which they are included the top-performing sector by far in the one-year period ending September 30th, though recently the shares have weakened.

In addition to investors, the sector has attracted the attention of companies in the alcohol, tobacco, and consumer products industries. The most prominent example of this was a CAD\$5 billion investment by U.S. liquor company Constellation Brands to increase its ownership interest in Canopy Growth to 38% with an option to purchase a majority stake. However, there are also signs of potential speculative excess evident in the sector, notably the performance of Tilray, an initial public offering whose shares rose 32% on its first day of trading to a market valuation of USD\$1.7 billion, and then soared 1160% ten weeks later to a market valuation of over USD\$16 billion, despite its having minimal near-term revenue prospects

From our perspective as equity investors, there are many unanswered questions surrounding these businesses and their shares. In the very near term there is likely to be a shortage of supply of cannabis to satisfy the new legal distribution channels, but based on announced capacity the domestic market is already oversupplied looking out just one year. The ongoing role of black market supply is also uncertain, but it is unlikely to disappear entirely. Six years after legalizing cannabis in Washington state, the black market still accounts for half of the overall supply. It is unclear where in the supply chain economic returns may be earned; the growing of cannabis may become a business similar to the production of other agricultural commodities, though some companies may be able to develop brands that will allow them to earn higher margins. The ability of Canadian companies to export or otherwise participate in opportunities outside of Canada is also uncertain. As with all nascent industries, there is a strong likelihood that not all companies operating today will still exist once the industry matures.

**For now, our investment teams are monitoring developments in this industry closely. Currently, most of the companies remain too small or too early-stage to consider for some of our investment strategies, but we are hopeful that a selection of robust businesses will eventually emerge that will merit potential inclusion in portfolios.**

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