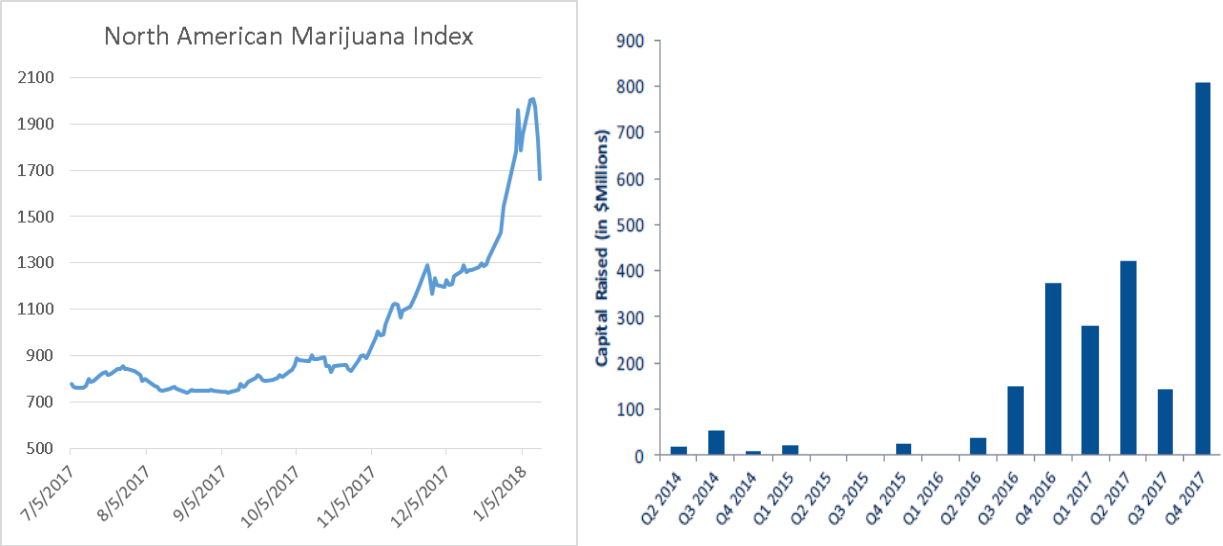
Half Baked?

A frenzy in marijuana stocks

Recently, we have been fielding many questions from clients about our thoughts on the nascent marijuana industry. It's no surprise, given the parabolic moves seen in many marijuana-related stocks. From September 30, 2017 to January 9, 2018, marijuana stocks as represented by the North American Marijuana Index appreciated an astounding 148%, attracting attention from across the investor spectrum. Meanwhile, financing activity from marijuana companies in Canada also increased substantially in the fourth quarter of 2017, reaching an all-time high of over $800 million.

Figure 1 – Marijuana Index Performance (LHS) and Total financing transactions in the marijuana industry (RHS)



Source: Bloomberg (LHS), Canaccord Genuity, as of January 12, 2018 (RHS)

So why the hysteria? In Canada, the outlook for the marijuana industry over the past several years has been linked to increasing regulatory clarity, with the current rally reflecting the impending legalization of recreational marijuana in July 2018. While the medical marijuana market has grown rapidly and has been a driver in its own right for many marijuana stocks, recent speculation has been more related to the opening of the recreational market this summer.

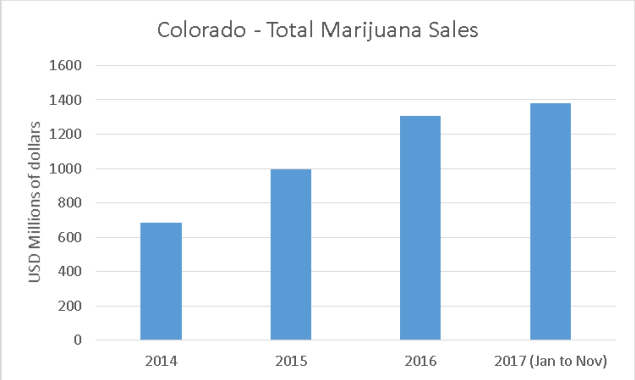
Some investors have speculated on the size of the recreational market and have drawn comparisons to the tobacco or alcohol markets. A study in 2016 by Deloitte estimated a base retail recreational market in Canada of $4.9 billion to $8.7 billion[1], which would put it on par with the spirit market (whiskey, vodka, rum etc.) at the lower threshold, or the wine market at the upper threshold. Including ancillary industries such as security, transportation, etc., the study estimates that total economic impact could be as high as $23 billion, not even accounting for

[1] "Recreational Marijuana, Insights and Opportunities" – Deloitte, October 2016

taxes and licensing fees. Meanwhile, Canada's Parliamentary Budget Officer (PBO) issued a report in November 2016 that estimates a total retail market for recreational marijuana of $5.5 to $5.8 billion.

Others estimating the size of the market in Canada point towards U.S. states that have already legalized recreational usage. For example in Colorado, a state approximately one-seventh the size of Canada, the past 3 years have seen substantial growth marijuana sales, with 2017 sales likely to come in at approximately $1.5 billion USD.

Figure 2 – Colorado Marijuana Sales since 2014



Source: Colorado Department of Revenue, as of January 2018

No matter how the estimate is extrapolated, the inference is that the size of the Canadian cannabis market will be large, and as a result the opportunities substantial. We would caution, however, that drawing direct comparisons with respect to market size with the tobacco or alcohol industries may be premature, as social acceptance of marijuana is still evolving. Nonetheless as the industry's steady state economics evolve, there will be winners in companies poised to claim a part of this multi-billion dollar market.

Risks Aplenty

The big question, in our view, is how much of that future is already priced in to marijuana stock prices. With sector stock prices moving in tandem, industry-wide fund flows have been the main driver and have pushed valuations up to unprecedented levels. Valuations are unquestionably expensive under conventional metrics such as P/E, or EV/EBITDA, and as valuations have continued to climb, sell-side analysts have used varying methodologies to justify their price targets, including using a two-year forward earnings or EBITDA multiple, as well as new metrics such as market cap to funded capacity ratio. This ratio measures a company's market cap against how many tonnes of marijuana that the company can grow in the future (capacity) where the company has already raised money to build out this capacity. As many marijuana stocks do not currently make money while they serve only the medical market, the metric has become useful for comparing valuation in different cannabis companies. Further, the metric continues to fluctuate as companies continue to announce plans to expand capacity and continue to raise money at a breakneck pace.

While the long-term growth prospects for the industry are attractive, marijuana companies are trading off a multiple of capacity that in many cases has not been built yet, which could be interpreted as an example of the exuberance in the market.

Staying disciplined

Marijuana stocks are still in their relative infancy, with market caps for only a select few eclipsing $1 billion even after the recent rally. Furthermore, as most of them continue to burn cash in order to expand their operations,

none are dividend-payers. As such, for many of the funds in our product lineup, the stocks are simply not in the opportunity universe.

One manager whose universe cannabis stocks falls within and who has exposure to the sector is Peter Imhof, portfolio manager for AGF Canadian Growth Equity Class*. Imhof has exposure to CannTrust Holdings in his portfolio, and had previously owned Aphria Inc. as well.

Our view is that the marijuana industry will become a legitimate industry, but while the recent gains have been intoxicating, we have taken a disciplined approach, seeking to buy the companies with the best management teams. We are more comfortable in companies that have a good operational track record and whose greenhouse growing operations have a cost advantage because of the availability of sunlight (as opposed to indoor growers).

Overall we believe that when marijuana is legalized for recreational use in July, it is possible that Canada will see a shortage in supply. However our belief is that these stocks may have already priced most of that in given the large moves they have already seen. Over the long-term, we believe dried marijuana will eventually become a commodity and the wholesale price is likely to come down over time as supply grows, particularly if Canada allows importation of marijuana from other countries (since the cost to grow is much lower in countries with warm weather and lots of sunlight).

While the recent exorbitant gains seen in marijuana stocks have been tempting, we believe a more prudent approach is to remain disciplined and to adhere to our established process. Over a full market cycle, we believe this approach will enable us to identify the winners in what is a continually evolving new industry.

*On April 10, 2012, shareholders approved a change in the investment objective providing the Fund with greater flexibility to invest in stocks of all market capitalizations.

Publication date: January 19, 2018