Cannabis - supply/demand suggests products, not growers could be the winners

As we wrote several months back, our view of the Canadian cannabis sector is that the rush of licensed producers (LPs) coming into the market will result in too much capacity being built and will ultimately lead to prices falling. For reference, Statistics Canada estimates that current Canadian demand (including black market) is roughly 773k KG[1]. Meanwhile, the public LPs that we track have plans to build more than 2.5m KG of capacity, and when you include the private companies this number grows even bigger. Ultimately, we believe the Canadian supply/demand dynamic could mimic that of the US. A recent article highlighted just how bad it is in Oregon[2]. Recreational cannabis became legal in October 2015 and less than three years in there is already 3x too much supply (1.1mlbs of production vs 340klbs of demand). The situation is so bad that the article quotes one grower who had to price his inventory at $100/lb in order to find a buyer. To put it into context, this represents a price of US$0.22/g wholesale vs Canadian LPs who are currently selling in the C$8-10/g range. We believe Canadian prices could eventually also drop and for this reason we are short a basket of some of the most expensive Canadian licensed producers. Although this basket was a detractor last month, we expect it to ultimately be profitable for the portfolio.

To be clear, we aren't negative on the entire Cannabis sector. In fact, our 3 biggest winners in the month came from long positions in Cannabis names. Namely, **Canopy** and **Organigram** convertible debentures, and the **Charlotte's Web** IPO. Given our view on the potential for flower pricing to drop, we have a negative bias to the equities of a number of expensive Canadian LPs. For that reason, we much prefer to gain exposure to the Canadian producers via convertible debt as they protect our downside while also allowing us to maintain upside exposure to rallies like we are currently experiencing in the sector. On the long side, we continue to look for companies outside of Canada that have value added products (i.e. not just price taking farmers) and real revenues. Charlotte's Web fits the bill as the company has US$54m in trailing sales and is actually profitable with positive net income. Given the positive fundamentals and our view that the IPO was attractively priced at C$7/sh, we expected the IPO to be well received, which it was as the stock ended the month at $10.50, 50% above the IPO price.

Looking ahead, we hold several Cannabis related positions, which we believe have the potential to appreciate substantially and offer attractive risk/reward trade-offs. Two names that fit this theme and that we have talked about in the past are the **Cannabis Strategies Acquisition Corp** (CSA/A CN) and the **CannaRoyalty** (CRZ) convertible debenture. As a reminder, CSA/A is a special purpose acquisition company (SPAC) looking to invest in the US Cannabis space. The company is looking to make one or more acquisitions totaling $150-300m. The structure of the SPAC means the company has to announce these deals within the next 10 months or it has to return cash to shareholders. Once announced, if shareholders don't like the deal, we are allowed to ask for our cash back with interest. This provides us downside protection while basically giving us a free call option on an attractive acquisition by CSA. We bought the CRZ convertible on the financing, as the conversion premium was only 14% above the stock price at the time and the company's valuation was relatively low vs US peers. Since that time the share price has increased so that the convertible is now in the money. CRZ's CEO has publicly stated that he wants to exit 2018 at a C$100m revenue run-rate, making us optimistic in our investment, as CRZ's market cap is still relatively low at roughly C$450m fully diluted vs US peers like MedMen and Green Thumb that trade at +C$2.5bn market caps.

Apart from these public investments we hold a few private companies in the US Cannabis space that are involved with retail and branded products. Some of these names are expected to be coming public within the next several months and we believe they could benefit from a substantial re-rate if the cannabis bull market continues.

Energy was once again a detractor

Despite WTI being up +1.5% in August, the S&P/TSX Capped Energy Index was down roughly 4.0%, as valuation multiples continue to contract. Stocks are being impacted by fund flows as "oil" has become a dirty word. The political climate isn't helping either, as the recent court ruling against the Trans Mountain pipeline (TMX) gives investors the appearance that Canada is happier to import foreign oil, rather than build its own resources and foster its own economy. The surprise ruling against TMX appears to have also caused investors to question whether LNG Canada will sanction a $40bn project in the current environment. This is a big change in sentiment as everyone was virtually certain the project would get a go-ahead this year as PM Trudeau, Premier Horgan and First Nations leaders are all supportive of the project and contracts were already being awarded.

We believe that the project will eventually go ahead, and we have positions in companies that have upside exposure to LNG Canada such as **Macro, Black Diamond** and **Enerflex**. We also believe a go-ahead decision would be positive for the energy sector as a whole, as it would improve sentiment by showing that Canada can actually attract capital and grow its economy. That said, despite being positive on prospects for the sector our overall exposure to energy is low and continues to decrease as we have been wrong/early amid a market backdrop where no one cares about oil stocks anymore.

Longest bull market on record, but is everything really that good?

US markets ended the month near all-time highs and there have been a lot of articles in the media about this being the longest bull market on record. While these facts would suggest that everything is great, we think otherwise, as one doesn't have to look hard to see cracks forming. Global stocks markets are not doing great with the MSCI All World Index down 6% from its highs. Germany, Spain, Italy and Brazil stock markets are down more than 10% from their highs, while China, Argentina, Turkey and Greece are down more than 20%. Lastly, South Africa officially entered a recession this week as Q2 GDP shrank by 0.8%.

For all these reasons, we remain cautious on markets and maintain a low net exposure in the JFT Strategies Fund (the "Fund"). That said, we have been increasing our gross exposure by adding companies with attractive risk-reward characteristics. Several of the companies discussed above, are some of our biggest holdings and we are optimistic about the potential to provide a lot of upside leverage with very limited downside exposure.

Source: Bloomberg as at August 31, 2018

Jean-François Tardif, President & Portfolio Manager, Timelo Investment Management Inc.

Sources:

1. https://www150.statcan.gc.ca/n1/pub/13-610-x/cannabis-eng.htm
2. https://www.wweek.com/news/2018/04/18/oregon-grew-more-cannabis-than-customers-can-smoke-now-shops-and-farmers-are-left-with-mountains-of-unwanted-bud/

Definitions:

P/E Ratio: The weighted average of the price/earnings ratios of the stocks in a portfolio. The P/E ratio of a stock is calculated by dividing the current price of the stock by its trailing 12 months' earnings per share.

P/S Ratio: This represents the weighted average of the price/sales ratios of the stocks in a portfolio. Price/sales represents the amount an investor is willing to pay for a dollar generated from a particular company's operations.

Earnings Per Share (EPS): is the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability

Sales Growth: The amount by which the average sales volume of a company's product or services has grown, typically from year to year.

Enterprise Value/Debt-Adjusted Cash Flow: Is commonly used to analyze oil companies and represents pre-tax operating cash flow (OCF) adjusted for financing expenses after taxes.

Free Cash Flow Yield: is a financial ratio that standardizes the free cash flow per share a company is expected to earn against its market value per share.

Free Cash Flow (FCF): Represents the cash a company can generate after required investment to maintain or expand its asset base.

Growth at a Reasonable Price (GARP): Is an equity investment strategy that seeks to combine tenets of both growth investing and value investing to select individual stocks.

Capital Expenditures (Capex): The amounts that companies use to purchase major physical goods or services that will be used for more than one year.

Compound Annual Growth Rate: The mean annual growth rate of an investment over a specified period of time longer than one year.

Mergers and Acquisitions (M&A): Is a general term that refers to the consolidation of companies or assets through various types of financial transactions.

Operating Cashflow (OCF): Is a measure of the amount of cash generated by a company's normal business operations.

Special Purpose Acquisition Company (SPAC): Is a publicly-traded buyout company that raises collective investment funds in the form of blind pool money, through initial public offering for the purpose of completing an acqusition of an exisiting private company.

(EBITDA) Earnings Before Interest, Taxes, Depreciation and Amortization: An indicator of a company's financial performance and is used as a proxy for the earning potential of a business.

Net Debt to EBITDA: is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. The net debt to EBITDA ratio is a debt ratio that shows how many years it would take for a company to pay back its debt if net debt and EBITDA are held constant.

Returns On Invested Capital: Is used to assess a company's efficiencyat allocating capital under its control to profitable investments.

Return on Equity: Is a measurement of a coporation's profitability by revealing how much profit a company generates with the money shareholders have invested

Capitalization Rate: Is a fundamental concept used in the world of commerical real estate.

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