The Canadian Marijuana Market Heats Up, but Investments Carry Risk

HEALTH CARE AND CONSUMER STAPLES SECTOR REPORT

18 October 2018

ANALYST(S)
Ashtyn Evans, CFA
Brittany Weissman, CFA

Buy-rated Companies Mentioned in This Report:

Health Care
• Johnson & Johnson (JNJ - $139.46)
• Merck (MRK - $71.82)
• Pfizer (PFE - $44.57)

Consumer Staples
• Saputo (SAP.TO - $38.86)
• Mondelez (MDLZ - $41.16)
• Philip Morris International (PM - $84.56)

Prices and opinions ratings are as of market close on 10/17/18 and subject to change.
Source: Reuters.

Summary

With the recent legalization of recreational marijuana in Canada, the industry has been receiving significant attention. As with any startup company in a new, growing market, inherent risks exist. An increasing number of competitors and changing regulations make it difficult to predict who the ultimate winners and losers will be. We would consider any investment in the marijuana industry to be speculative. We prefer investors gain exposure to the health care and consumer staples sectors through companies with a proven track record and a larger sales base.

Medical Market Is Relatively Small
Over the last year, sales for medical marijuana in Canada totaled over C$300 million (1,2). In comparison, over C$25 billion is spent on prescription drugs a year (1). While access for medical use is legal, marijuana has not actually been approved as a therapeutic product by Health Canada, like traditional prescription drugs (1). We prefer investors get exposure to innovation through biopharmaceutical companies that are diversified by product, geography and have an extensive operating history and experience bringing drugs to market.

Recreational Market Has Low Barriers to Entry and Many Uncertainties
While the recreational market is expected to be larger than the medical market, significant uncertainties exist. As with most new, growing markets, we believe the excitement over the marijuana industry will eventually fade. Given the low barriers to entry, we expect competition to increase, and with the rapidly changing market dynamics and regulatory scrutiny, it is difficult to assess who the handful of winners and many losers will be. Beyond market dynamics, we believe it is difficult to predict how and where buyers will choose to consume recreational marijuana and what portion of sales will remain in the illegal market. In food, beverages and tobacco, we prefer companies with strong brands, larger markets and a proven track record.

Limited Operating History
While medical marijuana use has been legal in Canada since 2001, it wasn't until 2013 that nongovernment suppliers were able to receive licenses to manufacture and sell (3). As a result, the companies involved in the marijuana industry in Canada have a limited operating history. In addition, the smaller size of these companies and uncertainties related to this new market have led to greater price movements of the individual marijuana stocks relative to the overall market.

Sources:
(1) Health Canada
(2) Public Safety Canada
(3) Canopy Growth Financial Statements
(4) AbbVie Financial Statements
(5) Bloomberg

Individuals can obtain the full research report with full disclosures on any of the companies mentioned in this report by contacting a local Edward Jones financial advisor, or write to: Edward Jones, 90 Sussex Centre, 90 Burnhambthorpe, Mississauga, Ontario, Canada, L5B 3C3.

Information about research distribution is available through the Investments & Services link on www.edwardjones.com.
The Marijuana Market

Medical Market
Over time the medical marijuana market in Canada has grown substantially as acceptance and access has increased. Current uses for medical marijuana include nausea and pain management, and it has received greater attention because the opioid epidemic has led to a search for alternative pain medications. We acknowledge that the medical market is poised to expand as more doctors become comfortable prescribing marijuana. However, we believe there are many uncertainties associated with the market, such as

• Small market size - The C$300 million size of the medical marijuana market in Canada is still relatively small when compared to the over C$25 billion Canadians spend on traditional pharmaceuticals, or the over USD$18 billion in annual sales that the largest global drug, Humira (autoimmune disease), has in sales (1,4).
• Lack of regulatory approval - Unlike traditional pharmaceutical drugs, medical marijuana has not been approved by any regulatory agencies, including Health Canada (1).
• Increasing competition - Nongovernment companies have only been allowed to grow, distribute and sell medical marijuana since 2013 (3). We believe competition will continue to grow over time, which could pressure prices.

Recreational Market
While the recreational market is expected to be larger than the medical market, significant risks exist for companies involved, such as

• Low barriers to entry and increasing competition - According to Health Canada, there are 80 sites with a license to produce, but there are over 400 sites with license applications in progress. In addition, it’s expected that citizens will be able to grow their own product in a limited amount (1).
• Price uncertainty - When considering market share, it is difficult to forecast how much share the illegal market will maintain. Price will be a very important factor. A low price could encourage use, which could lead to public health risks. A higher price would discourage recreational use, but if it is too high, significant share may remain in the illegal market. As the government considers taxes on products, there are significant trade-offs to consider.
• Changing regulations are another major risk and could differ by province. Canada's recreational marijuana is highly regulated, similar to alcohol and tobacco, where the cultivation, distribution, sales and consumption will all be regulated.

• Consumer behaviour - Beyond market dynamics, we believe it is challenging to predict consumer behaviour. We do not know where and how buyers will choose to consume recreational marijuana.

Other risks include safety and product recall issues, and general risks associated with agriculture. The total marijuana market could exceed C$8 billion by 2021, though it is significantly smaller than the alcohol, tobacco and prescription drug markets in Canada. In addition, the fact that it's a new market makes it less predictable, in our view.

Investments in a Startup Industry Carry Risks

Startup risks - Any startup company in a new, growing industry has inherent risks. Aside from the rapidly changing dynamics in the marijuana industry, new companies need to secure funding and fight for market share among the numerous competitors. Recreational approvals in other countries add a level of complexity and possible additional competition from companies outside of Canada. Larger companies could also get involved and disrupt the marijuana industry. As with the emergence of the Internet and subsequent "tech bubble" in related stocks early last decade, excitement can build with a new, growing industry. However, it is difficult to predict who will emerge as market leaders, and there will be many losers, in our view.

Limited operating history - The publicly traded companies that make up the marijuana industry in Canada have relatively limited operating history. This is because nongovernment manufacturers have only recently been allowed to sell medical marijuana. When recommending investments, we prefer companies with a solid track record, typically at least 10 years of operating history. This means that the company has generally faced at least one economic downturn, and that management has...
experience with adversity as well as success. In addition, most of the publicly traded companies in the industry are not profitable, as they are heavily investing in increasing production capabilities(5).

Small sales base - Again, when considering companies for investment, we prefer larger companies with a broader sales base of at least C$500 million per year. The largest marijuana company in Canada reported sales of C$40 million last year (5). Currently, none of the companies in the marijuana industry meet all of our coverage criteria.

Volatile stock prices - Due to the relatively small size and evolving nature of the industry, we expect the price movements of publicly traded companies in the marijuana industry to be above average due to the many uncertainties in both the medical and recreational market. We believe it is difficult to forecast the future sales and earnings of these companies, particularly given that the legal recreational market does not yet exist, and therefore significant assumptions have to be made.

What We Recommend

Given the size of the marijuana market, if any of the health care or consumer companies we currently recommend became involved in the industry, we do not believe it would be a meaningful part of their business at this point. For exposure to medical innovation, we prefer drug companies that are diversified by product, geography and have extensive operating history and experience bringing drugs to market such as Johnson & Johnson (JNJ), Merck (MRK) and Pfizer (PFE). Given the uncertainties related to the recreational market, we expect consumer companies to be limited in their involvement and favour partnerships. We view these investments as small relative to the size of these companies, and would not expect these partnerships to be meaningful to companies’ sales or profits in the foreseeable future. For food, beverage or tobacco companies, we continue to prefer those with strong brands, larger markets and a proven track record such as Mondelez (MDLZ), Saputo (SAP.TO) and Philip Morris International (PM).

Valuation - When valuing consumer staples and health care companies, we use various methods including, but not limited to, comparing price-to-earnings ratios (P/E) and PEGY ratios (price-to-earnings ratio divided by growth plus dividend yield) to historical and peer averages. We also use discounted cash flow models to incorporate long-term growth expectations.

Investment Risks - Some potential risks involved with investing in the consumer staples sector include deteriorating economic conditions, a slowdown in consumer spending, rising interest rates, higher commodity prices and currency fluctuations. Some risks related to health care sector companies include political and regulatory risks, pricing pressure, and product failures and/or liabilities. Please see the individual company research opinions for specific company information, including valuation and risks.

Sources:
(1) Health Canada
(2) Public Safety Canada
(3) Canopy Growth Financial Statements
(4) AbbVie Financial Statements
(5) Bloomberg

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Ashtyn Evans, CFA; Brittany Weissman, CFA

Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Other Disclosures

This report does not take into account your particular investment profile and is not intended as an express recommendation to purchase, hold or sell particular securities, financial instruments or strategies. You should contact your Edward Jones Financial Advisor before acting upon any Edward Jones Research Rating referenced.

All investment decisions need to take into consideration individuals’ unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

It is the policy of Edward Jones that analysts or their associates are not permitted to have an ownership position in the companies they follow directly or through derivatives.

This opinion is based on information believed reliable but not guaranteed. The foregoing is for INFORMATION ONLY. Additional information is available on request. Past performance is no guarantee of future results.

In general, Edward Jones analysts do not view the material operations of the issuer.

Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.
An index is not managed and is unavailable for direct investment.

Member - Canadian Investor Protection Fund