

# The Canadian Marijuana Market Heats Up, but Investments Carry Risk

## HEALTH CARE AND CONSUMER STAPLES SECTOR REPORT

### Buy-rated companies mentioned in this report:

#### Health Care

- Johnson & Johnson (JNJ - \$160.41)
- Merck (MRK - \$90.48)
- Pfizer (PFE - \$41.75)

#### Consumer Staples

- General Mills (GIS - \$76.41)
- Mondelez (MDLZ - \$55.62)
- PepsiCo (PEP - \$161.82)

Prices and opinions ratings are as of market close on 10/10/22 and subject to change. Source: Reuters.

#### Sources:

1. Health Canada
2. Public Safety Canada
3. Canopy Growth Financial Statements
4. AbbVie Financial Statements
5. FactSet 7/11/2022

### For more information:

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 advisor, or write to: Edward Jones, 90 Burnhamthorpe Road West, Sussex Center, Suite 902, Mississauga, ON L5B 3C3.

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### Investment Summary

With the legalization of recreational marijuana in Canada, the industry has received 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. There is also risk a company could be prosecuted should a company not act in accordance with U.S. federal laws. **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 --** While the medical marijuana market in Canada could reach over C\$1 billion in sales, over C\$40 billion is spent on prescription drugs each year (1). Though 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.

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Please see important disclosures and analyst certification on page 3 of the report.

## 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 size of the medical marijuana market in Canada is still relatively small when compared with the over C\$40 billion Canadians spend on traditional pharmaceuticals, or the roughly USD\$20 billion in annual sales that the largest global drug, Humira (autoimmune disease), has (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

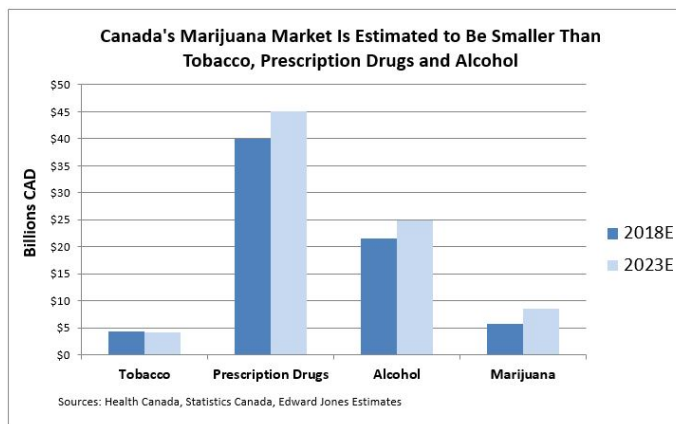
While the recreational market is expected to be larger than the medical market, significant risks exist for companies involved, such as

- **Low barriers to entry and increasing competition** - The number of license holders that are authorized to sell marijuana continues to increase. In addition, citizens are generally 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 is 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 2023, 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 because they are heavily investing in increasing production capabilities (5).

**Lack of Profitability** - When considering companies for investment, we prefer larger companies that are profitable and have a broad sales base. The largest marijuana company in Canada has roughly C\$1.5 billion in sales, though earnings are negative (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, because 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), PepsiCo, (PEP) and General Mills (GIS).

**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) with 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 research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.**

### 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.

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