Ian Cooke, CFA

The Greening of Canadian Equity Markets

Over the past year, Canadian marijuana stocks have garnered capital markets' interest in bubble-like fashion. Health care was the strongest performing sector in the BMO Small Cap benchmark last quarter, led by cannabis stocks roaring to new heights. The four largest marijuana stocks in Canada have had extreme rallies since the start of September, anywhere from 240-400%. Market enthusiasm continued this week when a $175 million bought deal was announced for Canopy Growth Corporation (ticker symbol: WEED). The deal was quickly upsized to $200 million. Notably, Bank of Montreal was involved in the transaction, marking the first time a major Canadian bank has participated in an equity financing for the marijuana sector. In commenting on the deal, The Globe & Mail quoted Canopy's CEO:

"I think this signals a new normal…What I think is going to happen is the institutional buyers who've said 'we don't really do this because banks don't do this' are going to say, 'shoot, we really should do this.'"

-Bruce Linton, CEO Canopy Growth Corporation

Mr. Linton is likely correct in his assertion. In March of 2017, Canopy was added to the S&P/TSX Composite Index. At that time, the market capitalization of Canopy was less than $2 billion. Management stated that they expected index inclusion to drive liquidity and increase the percentage of institutional shareholders. Today, the market capitalization has ballooned to over $7 billion and our understanding is that this week's deal had significant institutional interest. This was the 7th major financing in the Canadian cannabis space, with over $800 million raised since the start of the year.

Liquidity in the space is now abundant. Two years ago, a big day in the market for Canopy equated to around $3 million dollars of trading volume. Year-to-date, the average daily trading value of Canopy shares has exceeded $500 million. Every trading day this year, more money was transacted in Canopy shares than in any other business, except for the occasional day when one or two of Canada's largest bank stocks edged them out.

Even if most institutions avoid the space, the inclusion of marijuana stocks in major indices and ETFs could facilitate further demand for these stocks. ETFs are receiving record amounts of money and now represent a greater portion of the market than ever before. In addition to ETFs that track major indices, there are also specialized ETFs, including several dedicated specifically to the marijuana industry. Last week alone, two new Canadian marijuana ETFs filed for listing. Most ETFs are weighted based on the market capitalizations of the underlying stocks. There is no consideration at all for the fundamentals of the individual businesses. As long as the market cap of a stock is growing, the ETF industry will continue to demand more. As a result, these market products can add to momentum.

From what we can tell, the current buying frenzy in marijuana stocks has little to do with fundamentals. The majority of businesses have limited financial records and are burning large amounts of cash. Legalization for recreational use is targeted for July 1, but the provinces have yet to formulate rules around pricing and distribution. We simply do not know the definitive regulations that will govern the industry, have confidence in how the market will evolve, or which businesses, if any, will have enduring competitive traits. On top of all of this, the rampant interest in marijuana stocks has made the cost of entry extremely expensive.

Take four of the largest marijuana stocks traded on the TSX, for example. They now have an aggregate market cap exceeding C$18 billion, which is not far from the market cap of Molson Coors at US$17.9 billion. Molson Coors has the largest share of Canada's brewing market and generated approximately $13.4 billion in revenue over the past twelve months. This compares to only $148 million in revenue from the four businesses combined. Canopy, specifically, generated less than $60 million in revenue and recorded over $40 million in negative cash flow compared to more than $2 billion to the positive for Molson Coors. Is this business worth more than $7 billion dollars? For the answer to be yes, Canopy will likely need to command a presence similar to that of Molson Coors in the beer industry. The marijuana market will also need to grow to a size comparable to the Canadian beer market. It's not impossible, but we foresee the odds as very low. When capital is thrown at an industry in an increasingly indiscriminate fashion, the long-term returns on investment rapidly diminish. Caveat Emptor – Buyer Beware.