Why 2017 Is the Year to Invest in Marijuana

Description

Last December, a government task force laid out recommendations for legalizing recreational marijuana along with a roadmap to accomplish it by the end of 2018 or early 2019 at the latest. Supporting legislation will come before Parliament this spring.

It's no surprise that the news boosted stock prices for several of the publicly traded companies licensed to produce medical marijuana. **Canopy Growth Corp.** (TSX:WEED), owner of core marijuana brands Tweed and Bedrocan, is currently trading around $10 a share; it was trading below $4 as recently as September. Medical marijuana producer **Aphria Inc.** (TSXV:APH) doubled its share price from $2 to $4 since the task force announcement.

On the face of it, 2017 may be the year to jump into the marijuana market to get a piece of what looks to be promising growth over the next few years.

A closer look at the recreational marijuana market

In 2016, Deloitte partnered with Toronto's RIWI Corp. to examine Canada's potential recreational marijuana market. The report showed that 22% of the adult population currently uses recreational marijuana and another 17% may be willing to try it if it was legalized, indicating a substantial potential market of nearly 40% of adults. By comparison, 80% of adults consumed alcohol during the survey period.

The market numbers shake out like this:

- A base market of $5-8.7 billion annually (actual direct sales of marijuana).
- An ancillary market (growers, testing labs, security, other related marijuana products) of between $12.7 billion and $22.6 billion.
- A potential economic upside of $22.6 billion (tourism revenue, licenses, taxes, paraphernalia).

There's a potential economic impact exceeding $50 billion a year using high-end projections.

The potential upside in the near term

Canopy Growth, one of the most forward-thinking of the licensed producers (it recently acquired Mettrum Health Group, another marijuana production company, in anticipation of a burgeoning marijuana market), is a good test case.

Founded in 2014, the company has a current market cap of about $1.25 billion at $10 a share. It has been pursuing an aggressive growth strategy with carefully timed equity releases and a partnership with the Goldman Group to extend its production capacity and footprint.

The income statement may give investors pause, however, given its oversized market cap. In the quarter ending Sept. 30, Canopy reported revenue of just $8.5 million, although that represented an increase of 22% over the previous quarter and 245% over the same period last year. Stock prices have remained fairly constant in the $3-4 range until the recent year-end spike.

As the canary in the coal mine for the marijuana industry, Canopy is as good a choice as any. The company's share price has risen 275% over the past 12 months. Its annual revenue growth rate is a robust 435%. Looking out two years, analysts predict annual revenues of $138 million for FY 2018.

The company has ramped up its production significantly quarter over quarter and is poised to capitalize on the recreational market. In November, its most recent financial report showed production of 1,170 kilograms — up 267% over the same period last year. Of note, the Deloitte report puts recreational demand at 600,000 kilograms per year if legalization goes through.

Comparing marijuana to the high-tech industry

It's difficult to draw an apples-to-apples comparison between recreational marijuana and an established industry, but a look at Canada's high-tech sector is instructive.

The Brookfield Institute released a report recently indicating that high-tech is the fastest-growing sector of the economy, generating about $117 billion of the country's $1.65 trillion economy, which is about twice the high-end projected market for marijuana — and there's unlimited room for growth given the global demand for high-tech goods and services.

Astronomical growth has already been proven within the sector. The Deloitte Fast 50 Program identifies the fastest-growing companies in Canada's tech sector. The winner this year, **UrtheCast** (TSXV:UR) saw revenue growth of over 72,000% between 2012 and 2016.

Shopify Inc. (TSX:SHOP)(NYSE:SHOP) could serve as a bellwether for the industry. The company has a market cap of $4.5 billion; analysts predict revenues of $570 million in FY 2017 — up 50% over 2016. Monthly recurring revenue is up nearly 70% to over $16 million.

The stock prices have reflected the company's growth trajectory, more than doubling to over $51 from $22 a year ago. Shopify recently acquired Boltmade Inc., and a deal is underway to purchase Kit CRM. The stock is already trading above its 12-month price target of $50.

According to the Brookfield Institute, investment in Canada's high-tech sector was up 24% in 2015 and is on pace to exceed that for 2016. Over 60% of all venture capital deals in 2015 were in the tech industry, and R&D investment exceeded $9.1 billion in 2015.

For a short- to medium-term investor, the high-tech sector offers the potential for significant returns with a much broader basket of established equities from which to choose in order to hedge risk.

A look at the potential downside of marijuana

If you want to get in on the ground floor of legalized marijuana, it's a mistake to ignore the potential very significant risks. Legalization is not a foregone conclusion — and the challenges of implementing a legalization framework are not insignificant either.

Distribution on such a massive scale will be a challenge. The roadmap offered several different models, each of which has its share of detractors. One model suggests that the government would purchase marijuana from growers directly and then wholesale it to approved vendors — which would require an entire application, approval, and licensing process which has yet to be developed.

Another model uses government-owned liquor stores for distribution — an idea that has public safety officials up in arms over a potential increase in impaired driving. And, of course, Alberta doesn't use the provincially owned liquor store model, creating a new set of challenges.

Risks and rewards

For investors, marijuana remains an extremely volatile, risky, and uncertain market. Most publicly traded companies are highly speculative and trade OTC. The North American Marijuana Index launched in 2015, which includes about 23 companies with an average market cap of $239 million and a share price at or below $4.

The U.S. Index moved from $114 in January 2015 to $23 in February 2016 and currently rests in the $80 range. A framework for the retail sale of recreational marijuana was implemented in Colorado and Washington in 2014 with six more states and the District of Columbia following suit in 2015 and 2016.

The Canadian Index launched at about $100 in January 2015, fell to the $55 range mid-year 2015, and began a fairly spectacular climb in July 2016, peaking at over $330 in November on news of legalization before falling off to the $280 range currently.

The bottom line

There is potential for huge gains in marijuana, but timing your entry is extremely important. Once the legalization question is determined, it will take a year or two before customers begin queuing up to buy their first legal pot — and in the interim, many speculative companies will rise and fall in equally spectacular fashion.

Companies that support the burgeoning industry may offer a safer haven in the early stages, although returns will reflect the lower risk (think fertilizer companies, security companies, tech companies providing RFID technology for seed-to-sale tracking, that type of thing). If you're looking for a pure play in marijuana, keep your eye on Canopy, Aphria, and **Aurora Cannabis** (CVE:ACB) for 2017 and beyond.

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