



Aphria Inc. (TSX:APHA) Takes the Fight to Canopy Growth Corp (TSX:WEED)

Description

Most investor focus was arguably on revenue and operating earnings growth as **Aphria** (TSX:APHA)(NYSE:APHA) released its Q2 2019 financial results on January 11, but besides the [noted takeaways](#) from the earnings report, I find this little detail quite interesting.

The issue relates to a recently closed acquisition by **Canopy Growth** ([TSX:WEED](#))(NYSE:CGC).

Recall that a smaller Aphria entered a strategic partnership with a “leading international consumer lifestyle brand” Tokyo Smoke back in September 2016 in a deal that was dubbed the “first ever cannabis licensing deal in Canada between a consumer brand and licensed medical cannabis producer” in a press release on September 7.

The deal allowed Aphria to ship Tokyo Smoke branded medical cannabis in Canada to registered patients, and the cannabis grower’s chief executive Vic Neufeld commented that “when cannabis is legalized for recreational use in Canada, a strong brand will be one of the key differentiators for patients and consumers, and we’re committed to working with Tokyo Smoke.”

The foresight was just great, as Tokyo Smoke later became a high-value, award-winning brand over the next two years, and it got acquired by cannabis grower DOJA Cannabis. The new entity re-branded itself to Hiku Brands. Aphria went on to make significant strategic investments in Hiku and signed another supply agreement with the fast-growing consumer brands outfit.

Then Canopy [scooped Hiku](#) in a deal announced in June last year.

Aphria realized a sizable return on its equity investments in Hiku, and the new investor in the cannabis retail company could be reasonably expected to cancel any supply agreements with the competition.

Here comes the challenge

Aphria accepts Canopy’s decision to terminate the Hiku supply agreement, but it refuses to let go of the Tokyo Smoke deal, as it strongly believes that Canopy has no capacity to terminate the earlier

arrangement and “is pursuing all available legal options” to effectively block the “third party” from making such a move.

Is there any rationale to all this?

It's evident that Aphria stood to significantly benefit from a distributorship agreement with Tokyo Smoke, especially as the recreational cannabis roll-out gains momentum. Distribution deals will become more valuable as new players increasingly bring new productive capacity online and a new scramble for market access takes hold as supply outstrips demand.

I'm no legal expert, but it appears like the 2016 deal had some clauses that allowed it to sustain regardless of material changes in ownership, and the company may have a serious intangible asset to protect in such an instance.

Tokyo Smoke is one of the four private players to obtain a master retail licence agreement to operate up to 10 adult-use cannabis outlets in Manitoba, and the brand was approved for distribution in Alberta. Such distribution licences are serious intangible assets whose value increases if provincial authorities limit the number of issuable licences, as recently happened in Alberta in November 2018.

That said, it's reasonable to expect Canopy to terminate any distribution deals with close competitors as it invests in the Tokyo Smoke brand and spends a lot in marketing and branding efforts. The company wouldn't be comfortable carrying on a formidable competitor's brands and products on its platforms, even when the competitor talked to the previous owners of the acquired businesses first. It's not in Canopy's best interests to keep distributing a competitor's product.

Aphria has cashed out of Hiku (and Tokyo Smoke in the process), hence the company may not expect to have its prior deals with Hiku to sustain under Canopy and the new “landlord” is right in attempting to cancel the disputed deal.

Actually, I don't expect the legal battle to result in Aphria getting the agreement reinstated, but the company may receive some restitution for lost rights and economic benefits. The challenge is in the valuation of the disputed deal to determine compensation levels, especially if it covered a nascent recreational market as well as the United States market, which could soon come online as the legal landscape regime softens on cannabis regulation after the Farm Bill of 2018.

Foolish bottom line

The fresh legal battle between the two marijuana firms is just one of those interesting fights between close industry competitors as they work on maximizing the value of their investments and contracts.

Let's watch how the legal system decides on this one.

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