

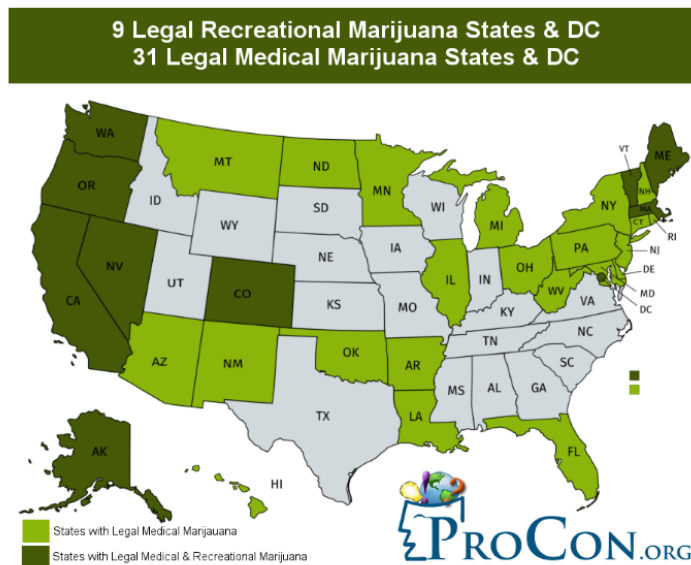
September 2018: Mood Modification

For the past three months, a day has not passed where a client hasn't asked: How does one invest in the growing marijuana and cannabis industry? Neither Stuart nor I have ever tried a drug. Truly. Honestly. We are nerds. At first, we did not know what to make of the inquiries (which actually started a few years ago but now occur daily). But as we began to dutifully research the investment opportunity (without complete due diligence which we will leave up to our clients who are so interested), one of us became more interested in the industry than the other. We have worked together for several years and this is the biggest disagreement we have had about potential investments. That is why one of us is writing the monthly rather than the other! This is probably not too dissimilar to the general population's view on the topic. If you support the legalization of marijuana you are probably still reading this letter; if you are against it, you are probably no longer reading this.

The following letter will not detail why cannabis should or should not be legalized for either recreational or medicinal purposes. I will leave that to others. The clients calling are NOT the kids of clients or the 2nd and 3rd generations. Rather most of our calls come from people who are eligible members of AARP. A common refrain is "All of my friends are doing it; it helps with arthritis or sleeping." Or as another person said, "You have the baby boomers doing it and you have the millennials doing it. That is a big market."

Legal Recreational Marijuana States and DC

Cannabis Laws with Possession and Cultivation Limits



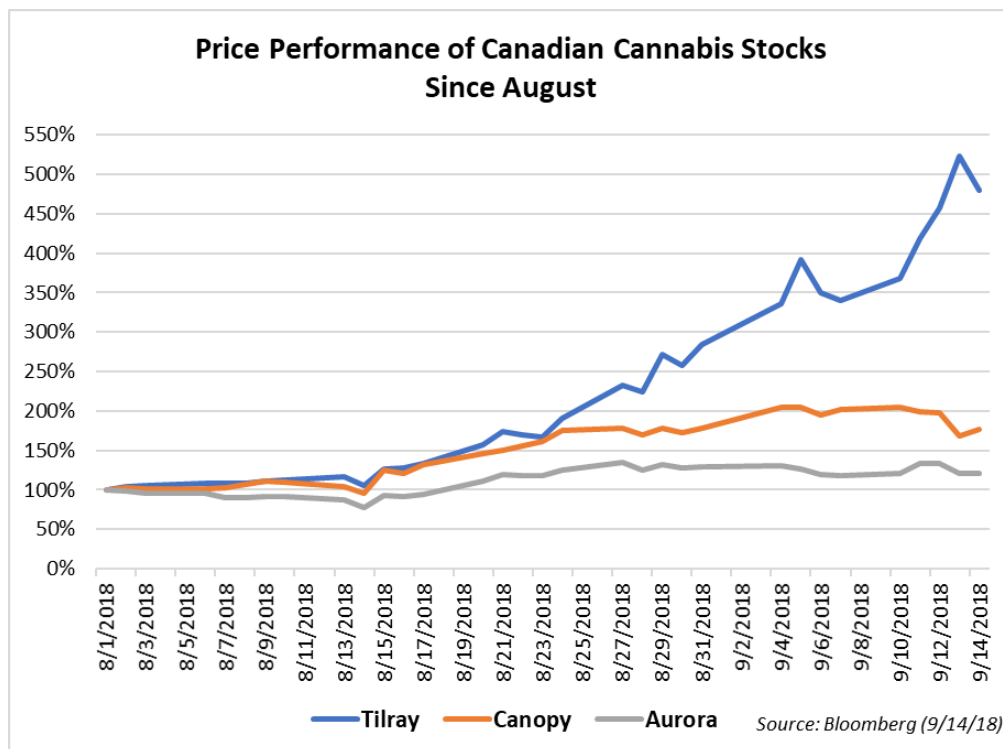
A total of 31 states have legalized medical marijuana with nine of them also allowing recreational use for adults. In all, 63% of Americans live in medical use states and 21% of Americans live in adult-use states.¹ A number of other states are also considering legalization. As you know (but may have ignored), the federal government has **NOT** legalized marijuana use. As a matter of fact, the Feds are doing all they can to hinder the commercialization of marijuana. For example – and this is a **BIG** problem – companies engaged in the marijuana industry have a very

difficult time banking with a federally chartered institution. So what does a dispensary do with all of that cash if it cannot go deposit the revenue at Chase? We have one client who was / is trying to set up a state bank to handle the funds. As part of our research, we were told some of the businesses involved will take 85 cents on the dollar if they could put their cold cash somewhere.

Additionally, some law firms will not take cannabis related companies as clients for fear of aiding and abetting a federal crime. Just yesterday, Politico reported that the U.S. Customs and Border Protection agency (the “CBP”) is threatening to put up the proverbial “Wall” to Canadians who “smoke marijuana, work in the industry or invest in the companies.” The Politico report states that the CBP is considering lifetime bans for such individuals from entering the U.S.² For the U.S.-based cannabis industry to grow, laws and regulations regarding banking and the use of marijuana will need to change. Without these changes, the growth potential is challenging.

Client interest in the industry increased after Canada’s Senate passed a law this summer legalizing marijuana use effective October 17th.³ Around the same time, Constellation Brands – perhaps best known for its Corona Beer and Mondavi wines – announced that it was investing \$4 billion for a 30% stake into Canopy Growth, which is an Canadian based cannabis company “offering distinct brands and curated cannabis varieties in dried, oil and Softgel capsule forms.”⁴ Canopy’s stock symbol is appropriately WEED.

The bitcoin of the Canadian marijuana industry is a company called Tilray which went public in July at \$17 per share. The stock price traded as high as \$127 yesterday, or as the graph below shows an approximate 450% since the beginning of August!⁵



Tilray has a market capitalization of \$11 billion. That is a “B” as in “boom” rather than “M” for “Millions.” This means Tilray’s market capitalization is greater than such old-time U.S. companies as Xerox, Harley Davidson and Mattel.⁶

Tilray announced its (lack of) earnings at the end of August. For the first six months of 2018, the company reported \$17.6 million in revenue. That is “M” for “millions” not “B” for “boom.” To reiterate, that figure is not profits, but revenues. The company reported a \$14.7 million operating loss for the same period.⁷

Tilray, Aurora Cannabis and Canopy Growth Corp are considered Canadian growth stocks just as Google and Amazon once were (or perhaps still are) U.S. growth stories. Because marijuana will soon be legal in Canada, the principal business location for these publicly listed companies is Canada. There are, however, a few companies which are publicly traded and focusing their operations in the U.S. And it is those handful of companies that we find more interesting than the Canadian peers. One important reason has to do with valuation. The Canadian companies have market caps of \$10 billion or more whereas the capitalization for the U.S. companies are a fraction of their Canadian brethren. Of course, one could justify this because marijuana will soon be legal in Canada and no one knows if or when that will be the case on a federal level in the U.S.

However, if the U.S. ever does legalize marijuana the potential is quite large. Take the recent signing into law by Illinois Governor Bruce Rauner of the expanded use of medical marijuana as a substitute for opioid prescriptions. According to the Illinois Department of Health, 2.3 million patients received about 5 million opioid painkiller prescriptions in 2017. While not all of those prescriptions can now substitute marijuana for them, a large number of them are expected to do so.⁸

According to Marijuana Business Daily (I never knew such a publication existed until I started the research and you should see the banner advertisements I now get in Chrome), cannabis retails sales in the U.S. were about \$9 billion⁹ or about \$1 billion more than McDonald’s U.S. sales in 2017.¹⁰ Total U.S. beer sales in 2017 were \$111 billion with \$26 billion of that in the craft beer industry.¹¹ The use of marijuana and consumption of alcoholic beverages are falling under a new category: Mood modification. The alcoholic beverage industry is worried that the legalization of drugs will cannibalize alcoholic sales as consumers shift usage from alcohol to legalized drugs. While the alcoholic beverages industry is concentrated amongst a few companies such as Constellation, Anheuser Busch Inbev, Heineken and others, the nascent and fledgling cannabis industry is highly fragmented. Thus, early movers who are awarded licenses could have a big advantage.

When I first thought about writing about cannabis, I inquired if I was allowed to. Government regulators like to regulate. They said I could, but they passed along the very useful following warning about fraud and manipulation:

“Scam artists often exploit “hot” industries to trick investors, including by making false promises of high returns with low risks. The SEC’s Office of Investor Education and Advocacy (OIEA) and Retail Strategy Task Force are warning investors about these kinds of investment schemes involving marijuana-related companies.”¹²

Thus, be forewarned if you want to invest in the industry. Clearly Tilray has provided high returns and at its current valuations also offers high risks. No pun intended on the word “high”; trust me this letter could have been full of them.

On a business note, we are thrilled to welcome Alissa Hirsh to our team. Alissa will work closely with the two of us. Alissa joined us from Hall Capital in San Francisco where she worked for two years in their hedge fund research group. Hall Capital has been a long-time friend of ours and when they called to say that one of their very talented analysts wanted to leave SF to move back home to Chicago, we jumped at the opportunity to meet with Alissa. She attended Niles North High School and graduated with honors in Economics from Grinnell College. Alissa left Grinnell as the all-time Women’s Basketball assist leader and third in career scoring. Alissa also plans to serve as assistant basketball coach for Niles North’s varsity women’s basketball team.

Sincerely,



Peter Karmin
Managing Member



Stuart Loren
Director

Citations and Disclosures

¹ Arcview Market Research “The State of Legal Marijuana Markets 5th Edition”

² <https://www.politico.com/story/2018/09/13/canada-weed-pot-border-783260>

³ Bloomberg LP “At 90 times earnings, Weed Stock Valuations Spark Jitters” September 13, 2018

⁴ <https://www.canopygrowth.com/investors/>

⁵ Bloomberg LP closing prices as of September 13, 2018

⁶ Bloomberg LP “At 90 times earnings, Weed Stock Valuations Spark Jitters” September 13, 2018

⁷ Tilray Investor relations <https://ir.tilray.com/news-releases/news-release-details/tilray-inc-reports-second-quarter-2018-earnings>

⁸ Chicago Tribune, August 29, 2018

⁹ “State of Legal Marijuana Markets, 6th Addition” SOLMM, Arcview Market Research and BDS Analytics

¹⁰ Bloomberg and McDonald’s Financials

¹¹ <https://www.brewersassociation.org/statistics/national-beer-sales-production-data/>

¹² <https://www.investor.gov/additional-resources/general-resources/glossary/market-manipulation> and Terri Grogan of GS Compliance Consulting

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