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WATCHLIST THE GLOBE AND MAIL

Canada's grand cannabis experiment is likely to end badly for this producer

MICHAEL MCCLOSKEY
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Michael McCloskey is the founder & president of GreensKeeper Asset Management

Cannabis. Everyone is talking about cannabis. We have a problem Canada.

I'm not talking about excessive cannabis use or temporary supply shortages. I am referring to the stock market bubble in publicly traded cannabis producers.

As value investors, investing in early-stage companies isn't our style. But having been bombarded by the media onslaught, we wanted to understand the industry from the bottom up including its business economics. Canada's grand cannabis experiment is likely to end badly for many investors and for Nanaimo-based Tilray Inc. (TLRY-Q -1.79%decrease) shareholders in particular.

By our estimates, the legal Canadian cannabis market (recreational and medical) will be about a $7.7-billion annual revenue opportunity at maturity. That figure doesn't include the illicit market, which is likely to persist until prices in legal channels become price competitive.

Long-term, the challenge for producers will be excess supply. By 2019, the production estimates of the ten-largest licensed producers alone will exceed Canada's projected domestic demand by 20 per cent. If we include the next tier of publicly traded licensed producers, the market will be oversupplied by 140 per cent. That excess grows further when we factor in licensed private companies and the 500+ companies awaiting licensing.

Even if the current production figures prove to be inflated, which we believe to be the case, supply will exceed domestic demand within a few years. When it does, prices will be driven down and margins with them. A supply glut may be good for consumers, but not for producers.

Cannabis-stock bulls argue that there is a massive international opportunity once other jurisdictions follow Canada's lead. We agree that a gradual opening up of the medical market elsewhere is possible. We are less convinced about the recreational segment due to the stigma and risks associated with cannabis use. In any event, politics and legislative processes will make this a long and slow evolution. Even if international demand does emerge, competition will be fierce.

There are limited barriers to entry in this industry for reputable companies with access to capital. For the Canadian market, producers that can successfully scale and drive down unit production costs are likely to succeed and make reasonable returns. Being a low-cost producer should give these producers an edge over smaller growers.

A few producers may also succeed by establishing consumer brands that users are prepared to pay a premium for. However, building a recognized consumer brand in a new market takes time and considerable investment. Value will ultimately accrue to the brand owner, not the farmer growing the commodity.

Even if a cannabis producer ultimately succeeds, that doesn't necessarily make its stock an attractive investment. A company's future profits need to be able to justify its current valuation. We view many of the publicly-traded cannabis producers to be vastly overvalued and Tilray even more overvalued than its peers.

Tilray listed its shares in the U.S. in July in a US$176-million initial public offering (IPO). The company serves both the medical and recreational cannabis segments with production facilities in Canada and Portugal. Tilray is still in the process of building out its production capacity, so its historical production rates are not very meaningful.

We examined Tilray's existing and announced production footprint and production yields being achieved by competitors including some currently operating at much larger scale. While the company expects to have production capacity of 150,000 kilograms by 2020, our estimate for Tilray is less than half that amount.

We made other reasonable estimates to derive a financial picture of Tilray in 2020. We also assumed that the company can achieve very high margins once they scale (in fact, our future profit estimates are higher than analyst consensus). We then applied a very healthy 25 times multiple to that future earnings estimate.

The result? Our estimated fair value for Tilray is 80 per cent below their current stock price. In other words, we believe Tilray's stock is massively overvalued.

If the domestic market cannot support Tilray's market valuation, perhaps international opportunities explain the valuation gap. According to the company, medical cannabis use is authorized in 29 countries and Tilray was the first company to legally export medical cannabis from North America to Africa, Australia, Europe and South America. To date, the company's sales of medical cannabis products outside of Canada are a meagre $1.3-million.

We are skeptical that international, CPG or other opportunities will be a material financial contributor for Tilray or any other Canadian cannabis company for the foreseeable future. In any event, with a rapidly maturing domestic market and at our assumed valuation of 25 times future earnings, we have given Tilray plenty of credit for those opportunities.

Tilray's medical cannabis production facility has been fully operational since 2016. The company's current revenue run rate is $38.2-million and Tilray has yet to earn a profit. Tilray has a current market capitalization of $12.2-billion.

The company is backed by Privateer Holdings – a cannabis-focused venture capital firm that owns over 80 per cent of the company. Due to an IPO lock-up agreement, Privateer is precluded from selling any shares until January 2019.

Put yourselves in Privateer's shoes for a minute and assume that after having supported the company financially since start up, you pursued an IPO that diluted your ownership at $17 per share in July. In the four months since IPO, Tilray's stock rocketed to $300 and then back to the current price of $99.49 (still up 485 per cent since IPO). Despite the pullback, your holdings are still being valued by the market at $9.8-billion. What would you do?

We would not be surprised to see lock-up shares come onto the market in January once released. In fact, we have bet on it (full disclosure: we own Tilray put options).

To be clear, we have no reason to believe that Tilray's management is anything but earnest in pursuing the company's mission and they have had some successes. Our negative view of the stock is strictly a valuation call combined with the near-term lock-up catalyst.

Like all market manias, this one will end badly. Current investors in Tilray should be careful to avoid having their investment go up in smoke.

Disclosure: GreensKeeper and certain accounts managed by it may hold long equity positions of a profiled company and may from time to time trade in these securities.