4th Quarter 2017

Newsletter

Investors Looking for Big Returns in Cannabis

The Big News is California and Colorado, USA. These states are the epicenter of the Legal Cannabis revolution and millionaires have already been minted. Canada is also front and center with the most forward looking legislation; it is still all in flux as in the USA Cannabis still considered an illegal narcotic at the federal level. But, that will surly change. Already, there is full legalization in Canada, with California and Colorado non-medical recreational sales by the beginning of 2018.

Suds Meet Buds: Constellation Brands (NYSE: STZ), the maker of Corona beer and Svedka vodka, has purchased a nearly 10% stake in Canopy Growth Corporation (TSX: WEED) for close to $200 million. This is the first time we've seen a major beer manufacturer enter the cannabis space, but it won't be the last.

That's not to say investing in cannabis isn't without its risks. But many of those risks — including a federal crackdown on states that have legalized — have never materialized. And I don't suspect they will in 2018, either. Because, as I've mentioned in the past, there's just too much money at stake at this point. Individual states that have legalized are now heavily reliant upon the cannabis industry for tax revenue and job creation. And with California, the sixth largest economy in the world, set to launch its own adult-use market in January, the industry is only going to become stronger. It should also be noted that next summer, cannabis for both medicinal and recreational purposes will be completely legal in Canada.

Make no mistake; the end of cannabis prohibition is coming. And, if you have any sense about you, take full advantage of this reality by getting yourself some exposure to the cannabis market.

Truth is, 2018 could end up being the best year yet. And this is mostly due to the launch of the California market, the Canadian market, and the political and social momentum behind the repeal of cannabis prohibition in countries all over the world.

Although Canada has become the global hub for the cannabis industry, and the U.S. is rapidly embracing legalization, we're also seeing new legalization developments in Mexico, Australia, Germany, Spain, Colombia, Uruguay, and Israel.

In 2012, Washington and Colorado became the first states in the USA to legalize recreational marijuana use. By 2020, it's expected that marijuana will grow to a $21 billion a year industry.

With all of the market hype surrounding this transition from illegal t legal, you might expect that, by now, there would have emerged several ETFs that target this high growth market, but we find investors who have been clamoring for a good way to get in on the cannabis trend have largely been unserved.

This is largely to do with the market being viewed as having a high risk of actually continuing a smooth transition from illegal to legal. Where at the federal level it is still a highly illegal industry with severe penalties and a discretionary and arbitrary application of federal law.

This all breeds uncertainty and therefore alters the risk reward perceptions in the market place.

The spreading of risk via a diversification tool, such as ETFs, has been slow to develop as investors see no benefit of diversification at this time. The market has little issue maturity, making it not very conducive to the application of standard efficient optimal portfolio management criteria. What's an ETF manager to do?

The high growth, that surrounds these market forecasts, is not the face that legalization or quasi legalization is going to create. New users or an increase in individual consumption is just not going to happen. The growth is only the replacement of the same level of illegal consumption with the now more measurable level of legal consumption. And consumption that will now be taxable, but at a cost of monitoring and enforcement.

People didn't stop consumption of alcohol because of illegality nor increase their consumption because it became legal again. The same can be said of Cannabis. People in Legal states are not going to say, "Oh, great, now I can start smoking reefer; it's legal"

Illegal markets, by their nature, have high transacting cost and markets that are government created and enforced monopolies also have high transaction costs in the form of enforcement, licensing, little uniformity of rules, etc.

A change in the cost of transacting as the volume of consumption moves from illegal purveyors to legal purveyors that will drive market structure.

ETFs to Market

The recently launched Horizons Marijuana Life Sciences ETF (HMMJ) only trades on the Toronto Stock Exchange.

That's about to change as the ETFMG Alternative Agroscience ETF is scheduled to begin trading later in December. The Alternative Agroscience ETF, the first U.S. traded fund dedicated to investing in marijuana cultivators and distributors,

The Marijuana ETF is still about a month and a half away, but here's what we know about it so far. It will track the Alternative Agroscience Index, an index that invests in companies that are primarily engaged in the legal cultivation, production and distribution of cannabis, pharmaceutical companies that manufacture or market cannabinoid-related drugs and businesses that make fertilizers and pesticides used in the cultivation of cannabis. The fund will only include companies that operate in states where marijuana is legal.

The potential for a marijuana ETF is huge; but in time.

Currently, 29 states and the District of Columbia have legalized medical marijuana, while 8 states along with DC have legalized recreational marijuana (Maine is still in a bit of legal limbo). Medical marijuana alone nets California an estimated $50 million in tax revenue per year. Colorado in its first year with legal marijuana raised more than $100 million in revenue. It raised $163 million in its second. Needless to say, with money like that on the line, states will find ways to make weed legal.

The $21 billion estimate in 2020 could very well end up being conservative.

Investors have already demonstrated their eagerness to get in on the boom.

The Horizons ETF is up 44% since it debuted in April. It's already built up more than $216 million in assets. Clearly, the interest is there.

There are over 300 small cap and pre IPO private issuances currently available in this space. Most, if listed, are on secondary exchange listings and "pink sheets" and trade with very limited volume via market makers.

Some of these companies are simply bogus pump and dump stories

The "Market" is still one of small caps (a few listed) and larger companies such as pharmaceutical companies and those who do not have a large concentration of their business in the MJ product or service space like fertilizers, Grow lights and mechanical delivery devices like vaporizers, transporting, consultants. Or, you might look to Beer giants waiting for the full legalization in order to offer Marijuana infused beer.

Yes, we will see more ETFs to provide the diversification and risk reduction the market so dearly needs, but we must remember that "the division of labor is limited by the extent of the market" and much of that division, in this market, is still illegal production and illegal distribution.

Illegal moving to a legal market will reduce the cost of transaction for both producers and consumers; information cost and personal consumption / production risk will fall. What will rise it a new set of enforcement cost as well as monitoring cost which must be covered by a myriad of new taxes; state and local.

The unit product price will fall but the taxation and monitor cost will rise. Illegality resulting risk, to both producers and consumers, will fall. But, the Illegal + legal market consumption total will stay the same it is just that we really don't know for sure just how large the illegal market still is after this limited legalization.

Current Industry leaders seem to be the exchange listed companies but all have been recent formations. Recent IPOs.

Major exchange listings or divisions of larger non-concentrated companies like RJ Reynolds, Bristol Myers, Budweiser plus Government created and maintained monopolies; via grow licenses for mega pot farms are some analysts' projections. Demands for inclusion or protection for small craft producers, limits on the retail outlets licenses being restricted as they move from medical dispensaries to maybe even 7/11 outlets?

So, what will the market structure look like going forward? Whole sale, Brokerage, Distribution, Transportation, Craft growing, Home Grow technologies, Extraction Labs, Vaping, Branding, Testing and Monitoring Will the market ultimately mimic the wine and beer industry? Mimic the Tobacco industry? Retail outlets industry; even the 7/11 model? Home delivery? Internet?

With taxation and high enforcement cost to limit competing entrants, there will still be a viable illegal market to deliver specialty product at a lower cost than legal purveyors.

- Maybe small home grow operations will ultimately prevail like home brew or the craft brewers and large producers will I like Gallo wine of vin ordinar'
- Maybe you invest in the Home Grow tech and implements and we will have no viable commercial producers; just a bunch of home farmers.
- Maybe it will be only oils and concentrates and dabbing and vaping and no one will remember how to roll a refer, spiff or joint again.
- Old school joint with your cup of coffee in the morning will be a thing of the past.
- In the medical space CBDs oil will also be big where the THC byproduct is sold right along with the Medical oils.

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A "New" Marijuana ETF Is on the way

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The Alternative Agroscience ETF, the first U.S. traded fund dedicated to investing in marijuana cultivators and distributors, is actually going to be a complete rebuild of an existing fund.

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Canada has beat its neighbor. When it comes to medical and recreational marijuana legalization, Canada now has a system that has worked in ways the U.S. could have emulated. Unfortunately, we're still trudging through, state-by-state, with the threat of a massive test of federalism looming over us. Meanwhile, Canada calmly dropped a practical system of rules back in April 2017, and in the process set up major advantages for Canadian pot companies that will have international implications for many years to come.

Analysts widely expect the new market to eclipse beer, wine, and liquor in sales within a matter of years. And that is just on the home front. Your companies are already exporting products to countries around the globe. An existing market, with established, well-capitalized players, is about to see a massive race to capture market share and sales. And while there are plenty of opportunities for investors in the U.S. as medical marijuana becomes the norm and legal recreational use spreads, only a fool would ignore the Canadian companies on the rise right now.

Vastly Different Regulation

The differences between Canadian and U.S. regulation couldn't be starker.

The underlying systems of government are fairly similar. Both countries use a federal system, with a degree of autonomy for provinces carved out where national government doesn't intrude or overrule.

When it comes to marijuana laws and regulations, the approaches are polar opposites, with U.S. legalization limited to the local and state levels, while Canada is building a framework from the top down. The U.S. marijuana industry is completely fragmented as a result. Companies cannot expand, or transport and sell, any products over state lines. The top-down Canadian approach is far different and well established. Back in 2001, the courts mandated exemptions for medical marijuana in drug laws. This system stayed stagnant until 2013, with patients either growing their own, designating a person to produce for them, or buying directly from Health Canada, the only authorized mass producer.

Between 2014 and 2016, that changed again. Commercial interests were allowed into the market, and now 36 licensed Canadian producers are active. And it is on top of this existing system that the new recreational rules have been added. There isn't a scramble to build businesses from the ground up. These companies already exist. Nor will there be any real threat of legal limbo for companies. Instead, in Canada, there is a clear path forward, which will soon provide a massive expansion of the market for the best companies to capture.

When looking at legal cannabis stocks, one thing you have to understand is that while the industry is booming, there are still only a small handful of stocks that can actually make you any money. And, these are the stocks that represent companies that are delivering on <u>three very important metrics:</u>

- Capital,
- Market share and
- Management.

Although the legal cannabis market is still relatively young, it's insanely cutthroat. And only those companies that are well capitalized will be able to successfully compete in 2018. Olympia Equity Analysts won't touch a cannabis company that doesn't have a **war chest of capital** going into 2018. The market is getting too competitive, and those that are not well capitalized will be out of business by the end of next year.

Market share is also incredibly important. This is where Canada really shines, as the biggest players in this market also have exposure in other countries, including the U.S., Germany, Colombia, Israel, and Australia.

And, of course, **management** is key. In fact, I often say that it's management in which I invest, not companies.

Similar to the way we've seen this factor play a role in the success of stocks like Tesla (NASDAQ: TSLA), Amazon (NASDAQ: AMZN), and Apple (NASDAQ: AAPL), the same holds true of the cannabis space.

A few of these companies that might meet the 3 criteria includes the following:

- Emerald Health (TSX-V: EMH)
- OrganiGram Holdings (TSX-V: OGI)
- True Leaf Medicine (CSE: MJ)
- Hydropothecary (TSX-V: THCX)
- The Green Organic Dutchman (Expected to IPO in 2018)

**With selection, due diligence is paramount

Break Big Pharma's Painkiller Monopoly

Big Pharma executives are running scared. Their $300 billion a year pill mill is about to be shattered forever. Pain-relief pot could make big pharma's painkillers obsolete. It could save millions of pain victims from opiate addition and risk of death. Pain-relief cannabis sales just might surpass the $35 billion that has been generated by OxyContin; going forward in future years.

It's easier now than ever since over half of all U.S. states have legalized medical marijuana. And, the remaining 23 states will soon legalize medical marijuana since they want a slice of the $3 billion in annual revenue that could be generated from taxing pot. What's more, by July 2018 Canada will have ***FULLY LEGALIZED*** marijuana for recreational use.

CBDs

"Using marijuana to treat chronic pain might help cut down on opioid abuse"

The key to marijuana's success with helping pain sufferers is that it reverses inflammation – the underlying cause of most pain. That's because marijuana contains healing compounds called cannabinoids. At least 60 of them have been discovered in the marijuana plant. The most effective of these cannabinoids is one called **"CBD."**

CBD has applications for almost every disease, without toxic side effects or the "high." These include...

- Cancer
- Heart Disease
- Alzheimer's
- Diabetes
- Lung Disease
- Inflammatory Bowel Disease (IBS)
- Neuropathy
- Multiple Sclerosis

The reason why pot helps people with chronic pain and these medical conditions is because these cannabinoids are more easily absorbed by the body. In fact, marijuana seems to be uniquely designed to work in tandem with the human body in a way that other compounds can't. Marijuana treats the body in a way other drugs and treatments can't...

Another HUGE benefit is that it's non-addictive.

That's so important because addiction to painkillers is a nationwide epidemic that claims lives. Several years ago, painkillers which are usually based upon "opiate compounds" took 14,000 lives annually. Last year, deaths doubled to 28,000, and shows no signs of stopping. All told, 2 million Americans struggle every year with the nightmare of pain pill addiction. Luckily, marijuana has emerged as the ultimate alternative for pain sufferers everywhere.

Many say it cuts their need for painkillers. And, this might surprise. The CDC found that *seniors* are the fastest-growing demographic of marijuana users. Use of pot has surged among the elderly by over 455% in the last decade.

The Marijuana Machine Rolls Ahead

Legal weed has been a financial boon, no doubt. But only recently have we begun to see the tangible effects of the flooding cash. Colorado's 938 dispensaries generated $65 million in state taxes, *Bloomberg* reports. Of that, $6 million was shared with cities, which used the money to plug budget holes and repair decrepit infrastructure. Furthermore, the cannabis grower is spending locally, buying GPS-controlled tractors and dozens of other agricultural products from nearby stores. Roughly two-thirds of construction under way in unincorporated areas is cannabis-related, according to city officials.

State tax revenue from marijuana sales exceeds $1 billion. California alone anticipates another $1 billion in annual tax revenue from legalization. But with an impending January 2018 deadline to begin issuing permits, there are signs that growers and retailers may not join the state-regulated system. Hezekiah Allen, executive director of the California Growers Association, estimates that just 3,500 of 40,000 farmers have signed up for permits but says that's primarily because local governments haven't issued them or have banned marijuana businesses outright.

California grows 13.5 million pounds of marijuana annually; less than 20 percent of it is consumed there. Growers may have to downsize as new rules ban out-of-state exports. If California's markets open in January and many existing growers are left out, tax revenue could fall short, and a robust black market will persist. To become legal, marijuana businesses have to secure building permits and water rights and establish record-keeping protocols unfamiliar to an industry that's long operated in the shadows. It's going to take decades for California to regulate its cannabis industry because it's been decades making this mess, and it's going to take us a while to clean it up.

Two of the current major players are:

Aurora Cannabis (OTC: ACBFF)

Canopy Growth Corp. (TSE: WEED)

U. S. Attorney General Jeff Sessions has nothing but criticism for cannabis, and in most cases, those criticisms are wildly inaccurate.

"I don't think America is going to be a better place when people of all ages, and particularly young people, are smoking pot," Sessions said recently. "I believe it's an unhealthy practice, and current levels of THC in marijuana are very high compared to what they were a few years ago, and we're seeing real violence around that."

Simply put, NOTHING about this statement is true.

To the contrary, legalization so far has been associated with lower youth use rates and access, increased tax revenue, and fewer arrests of otherwise law abiding American citizens. You'd be hard-pressed to find any real data that suggests otherwise. For that reason, nationwide cannabis legalization is inevitable.

Some 31 states are currently facing budget deficits. So, too, is the federal government. And as Colorado, Washington, and others have demonstrated, legalization means a lot of green. If Delaware legalizes pot, it won't be long before Maryland, Pennsylvania, and New Jersey get tired of watching their residents drive across state lines to spend tens of millions of dollars. States are going to keep falling like dominoes and the federal government will fold on the issue as soon as it reaches critical mass.

Technology Evolving

As more people turn to vaping, and more devices continue to hit the market, many in the industry are now embracing business models used by technology leaders to accelerate sales. This typically involves producing high-end, upscale products that launch regular upgrades. The rapid evolution of technology, along with strategic business initiatives, are working to ensure last year's model is always topped by this year's more advanced and alluring version.

Vaporizer manufacturer PAX Labs provides a prime case in point of ongoing innovation as well as sales. The company reports selling more than one million of its first three devices, which retail for up to $275 each. Vape Company Kandy Pens saw a 350 percent increase in sales in 2016, bringing its total up to $6.5 million.

E-Liquid Evolving

Just as consumers are turning to high-end vaping devices, they are also getting choosier when they buy e-liquid. Thousands of different flavors and hundreds of brands are on the market, although several e-liquid manufacturers are finding ways to stand out. Here the smaller companies can actually enjoy an edge over larger competitors, with the flexibility and creativity to produce exclusive products targeting niche markets.

Black Note is a case in point here, a tobacco e-juice company that manages to hit a revenue range of $1 to $5 million with a team of just 10 full-time employees. Black Note targets adult smokers only with its lineup of six high-end tobacco e-juice blends. Each blend contains real tobacco extract, undergoes and extensive, nine-step process, and can take up to two years to create.

Branding is taking off as an important way to distinguish between options, and storefronts are being renovated or relocating to posh neighborhoods. Top talent is being recruited into what were once small businesses, which in turn are being snapped up as the industry is rapidly consolidating wherever possible. Sales and revenue are skyrocketing, and new potential is being tapped faster and faster as businesses are finding innovative ways to fund expansion and capture market share.

But what I'd like to draw attention to is another sign... one that may look ominous but is actually good for smart investors.

And here is why this is a good thing...

The number of growers has hit the point where they are competing for business in a rapidly maturing market.

Falling cultivation prices are a good thing for investors in this regard.

It helps separate the wheat from the chaff. The companies that are going to move into these new markets as states legalize will hit the ground running, with efficient bottom lines and tried-and-true best practices. Make no mistake about it. The early years of the marijuana sector are effectively over. Welcome to one of the many pitfalls awaiting those tempted to leap into the biggest horticultural investing craze since the Dutch went wild over tulips in the 1630s.

The industry faces a raft of stiff regulatory and financial hurdles even where it's operating legally.

U.S. federal prohibition makes it hard to get normal banking services and impossible to ship products across state lines. Big investment banks, large private equity and venture capital funds and major U.S. stock exchanges have all steered clear, making liquidity and credit lines hard to come by. It's not for the faint of heart or those in search of quick returns. A big chunk of the capital invested in the flood of cannabis-related startups is certain to go down the drain, and it could take years to wring real value out of the survivors.

There's no doubt the risk appetite has to be high, and you have to view yourself as an early pioneer and believe in the movement – beside the economic upside, It's not a game for the timid. You really have to know what you're doing or you will be skinned.

But unlike the tulip mania that ultimately devastated Dutch commerce, marijuana is already a multibillion-dollar business and poised to grow much larger. Legal pot sales in Canada will hit $3.65-billion (U.S.) by 2021, up from $1.07-billion for medicinal marijuana this year, according to the latest projections from BDS Analytics, a cannabis specialist based in Boulder, Colo. Consumer spending on legal cannabis products across North America reached $6.7-billion last year, up 30 per cent from the previous year. And it's expected to soar to nearly $23-billion in 2021 – about $15-billion of it for recreational use – as more U.S. states defy the federal ban to tap into this lucrative new source of tax revenue.

So it’s not surprising that high-net-worth investors are pumping hundreds of millions into a slew of pot-related ventures ranging from cultivators, marketers and product developers (cannabis beer anyone?) to software designers, labs, fintech providers and data miners.

Contact Us for further discussions on this new evolving market. Our analysts at Olympia follow this market very closely.

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