

Business

Rocky Mountain high: investing in the Canadian cannabis market

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(May 9, 2017, 8:42 AM EDT) -- Since the Trudeau Liberals won a majority in the 2015 federal election, a seminal chapter in the evolving Canadian cannabis story, the legal framework surrounding cannabis use in Canada has been steadily loosening.

The changing landscape is fuelling fast growth in a relatively nascent market sector. Licensed producers (LPs) under the Access to Cannabis for Medical Purposes Regulations are scrambling to grab their share of a burgeoning Canadian medical cannabis market, which is forecast to peak at \$1.1 billion by 2020 — and this figure blossoms to \$2.5 billion assuming full legalization for recreational use.

LPs are accessing the Canadian capital markets at a feverish pace to finance increased growing capacity and complete complementary acquisitions of other LPs or production facilities. Since the federal election, publicly listed LPs have raised more than \$980 million in equity.

The current landscape is set for a tectonic shift. On April 13, 2017, Bill C-45, *An Act respecting cannabis and to amend the Controlled Drugs and Substances Act, the Criminal Code and other Acts* was published. The act regulates possession and commercial activity involving cannabis for medical or unqualified adult use. The government of Canada has set a goal of July 1, 2018, for implementation of the act.

The full effect of the legalization of cannabis for adult use on the Canadian capital markets has yet to be seen, but many observers predict the Canadian market for cannabis getting even hotter.

Investors in the sector should proceed with some caution. Many complex issues surrounding the “legalization” of cannabis in Canada remain murky. Details relating to the marketing and distribution of cannabis and the enforcement of cannabis use that will ultimately shape the adult use cannabis industry in Canada will only become clear once the act is finalized and consequential amendments to related legislation and provincial laws are put in place. This evolving regulatory regime presents risks to investors.

Our neighbours to the south have smelled the smoke and want to crash the party. In the U.S., although an increasing number of states have legalized cannabis for medical or adult use, cannabis remains a Schedule I controlled substance and is illegal under U.S. federal law. This anomalous regulatory environment creates significant legal risk for cannabis producers and other companies in the cannabis ecosystem, particularly with respect to interstate commerce.

As U.S.-domiciled cannabis companies head north to list and raise capital in Canada, investors should take heed of the significant legal risks faced by these companies at home. The rapid growth of Canada's cannabis market has spurred a new wave of collective investment vehicles focused on the sector.

Collective investments can take a number of forms and present opportunities for investors and for businesses alike. Private equity funds and a handful of labour sponsored funds, whose objectives include investments in LPs, have been actively investing in the industry. These funds will often take significant minority or controlling positions in privately controlled operating businesses or publicly listed companies and help finance the development of the businesses.

Real estate investment trusts (REITs) that invest in real property to be leased to or otherwise occupied by LPs may also be structured as collective investment vehicles targeted on real property, a key aspect of the operations of LPs.

Royalty companies present another investment model. A royalty company will generally invest in an operating company in return for a royalty stream based on revenue or income earned by the operating company (or a segment of the business, including intellectual property). The REIT and royalty models provide an investment opportunity, while possibly insulating the investor from certain risks associated with an operating LP.

Horizons ETFs Management recently launched an exchange traded fund, "Horizons Medical Marijuana and Life Sciences ETF," whose investments are focused on a basket of North American listed LPs and related companies (including investments in fertilizer companies). Although the ETF does not provide direct funding to businesses, it does allow investors an opportunity to invest in a diversified portfolio of publicly traded securities.

One of the challenges for the managers of any fund or other collective investment vehicle will be to develop rigorous investment policies and processes that not only contemplate a review of the business but also focus on compliance with the regulations. The legalization of cannabis for unqualified adult use will involve the stringent regulation of every aspect of the cannabis market — from seed to sale — including the production, marketing and distribution of cannabis products.

Investors should be mindful of the need for strict regulatory compliance by the LP or other operating company.

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