



CANNABIS – THE NEW NORMAL

Consuming cannabis is the new normal. In 2013, Uruguay was the first country to legalize recreational cannabis. In 2018, Canada was the first industrialized country to legalize recreational cannabis. Today, there are over fifty countries that have legalized medical and/or recreational cannabis. Globally, legal cannabis sales, which totalled USD \$15 billion in 2019, are expected to increase to USD \$47 billion by 2025, a compound annual growth rate (CAGR) of 21%. In most industries, a 21% CAGR is attractive, but many investors have ignored the opportunity to invest in the cannabis industry because of the complexities and the stigma associated with cannabis. However, the opportunity should not be overlooked.

The World Health Organization's (WHO) recommendation to reschedule cannabis could be the catalyst for global cannabis policy reform. Under the United Nations' (UN) Single Convention on Narcotic Drugs, cannabis is categorized alongside cocaine and heroin as a dangerous substance with no medical benefit and a high potential for abuse. The WHO recommends de-scheduling cannabis from Schedule 4 (the most restrictive category), de-scheduling cannabidiol (CBD) and rescheduling tetrahydrocannabinol (THC) to Schedule 1 (the least restrictive category). These recommendations recognize the potential benefits of medical cannabis and if the UN adopts these recommendations in December 2020, expect member countries and non-member countries to review their policies on cannabis.

Legalization is gaining momentum. In Asia, where trafficking drugs is punishable by death in many countries, it's important to note that South Korea, Sri Lanka and Thailand have legalized medical cannabis. In New Zealand, voters will decide if recreational cannabis should be legalized at the next general election in October 2020. In Mexico, the Supreme Court ruled that the prohibition of cannabis is unconstitutional and mandated the government to legalize recreational cannabis by December 2020. In Israel, the government advanced two cannabis related bills and expects to legalize recreational cannabis through a legislative process by 2021. In Luxembourg, the government announced plans to legalize recreational cannabis through a legislative process by 2021. In the U.S., Arizona, Mississippi, Montana, New Jersey and South Dakota could legalize recreational cannabis through a ballot initiative at the next general election in November 2020 and there is a possibility that Nebraska and Oklahoma will be added to this list. Additionally, Pennsylvania is expected to legalize recreational cannabis through a legislative process by 2021.

A Democratic victory at the U.S. presidential election in November 2020 is expected to be a net negative for the U.S. economy, but a net positive for the cannabis industry. Most polls are predicting a Democratic victory, where Joe Biden will become the next President and Kamala Harris will become the next Vice President. Joe Biden has indicated that he would support decriminalizing cannabis,

legalizing medical cannabis, expunging all prior cannabis related convictions, rescheduling cannabis from Schedule 1 (the most restrictive category) to Schedule 2 (a less restrictive category) on the Controlled Substances Act and he would allow individual states to legalize recreational cannabis without federal interference. Cannabis is illegal at the federal level and will likely remain illegal under a Joe Biden administration. Kamala Harris supports legalizing cannabis, sponsored the Marijuana Opportunity, Reinvestment and Expungement (MORE) Act and co-sponsored a number of cannabis related bills including the Marijuana Justice Act and Secure and Fair Enforcement (SAFE) Act. In addition to winning the White House, if the Democrats win both the House of Representatives and Senate, where there is already bipartisan support, expect cannabis policy reform to gain traction. Currently, there are thirty-three states that have legalized medical cannabis and eleven of these states have legalized recreational cannabis.

The U.S. Food and Drug Administration (FDA) is expected to provide guidelines on marketing CBD as a dietary supplement. Hemp, a cannabis plant with a high percentage of CBD but less than 0.3% THC (the legal definition), was legalized by President Donald Trump in December 2018. Hemp derived CBD is the primary input in health and wellness products associated with cannabis, but the FDA advised that these products are excluded from the definition of a dietary supplement and that it is illegal to claim that CBD has health benefits. In addition to the medical market and recreational market, the health and wellness market could experience significant growth if and when the FDA provides guidelines.

In Canada, legal cannabis sales are expected to accelerate with an increasing number of retail stores and the launch of derivative products. Ontario, the largest province by population, transitioned from a lottery system to an open market earlier this year and is expected to increase the number of retail stores from approximately 100 to over 1,200. The legalization of derivative products will attract new users and provide a lifeline for the struggling cannabis companies operating in Canada, as derivative products have higher price points and higher margins when compared to flower products. Legalization in Canada has been far from perfect and the fundamentals are deteriorating. The market is oversupplied and many companies remain unprofitable, desperate for cash and must shrink to grow, which is the result of poor capital allocation decisions.

Job creation and tax revenue are two of many reasons to legalize cannabis in an economic downturn. Legalizing cannabis can counter rising unemployment rates and government deficits caused by the current pandemic. For example, in the U.S., it's estimated that the cannabis industry currently employs over 200,000 people and this number is expected to exceed 500,000 by 2025. Colorado is the most mature legal cannabis market in the world and has collected over \$1 billion in tax revenue since legalizing recreational cannabis in 2014. With unemployment rates and deficits at elevated levels, many states are considering legalizing cannabis to stimulate their economies.

The cannabis industry is capital constrained at the moment, but it's expected that capital will begin flowing again. Thirteen special purpose acquisition companies (SPAC) raised over USD \$3 billion since June 2019. It's estimated that half of this capital has already been deployed and the other half will be deployed in the near-term. A SPAC is formed to raise capital through an initial public offering for the purpose of acquiring cannabis assets within a specific time period, usually twelve to twenty-four months. Additionally, the cannabis industry is underfollowed by institutions, mostly because of the legality of cannabis in their jurisdictions. With that said, we believe that institutions are sharpening their pencils on the cannabis industry and it's a matter of time before they start investing in cannabis companies. For example, Alberta Investment Management Corp., British Columbia Investment Management Corp., Canada Post Corporation Pension Plan and the Public Sector Pension Investment Board have all made investments in the cannabis industry. However, not all cannabis companies are created equal and only the cannabis companies with a strong track record will have access to this capital.

At Matco, we have been following the cannabis industry since 2014, investing in cannabis companies since 2016 and launched one of the first cannabis funds in Canada in 2017. Through our due diligence, we believe that long-term investors will be rewarded with strong returns, as the cannabis industry continues to transition from an illegal market to a legal market. The cannabis industry is evolving quickly and we believe that active management, along with fundamental analysis, will be primary drivers of returns going forward. For example, the Matco Cannabis Fund has limited exposure to Canadian licensed producers, which are the companies that make headlines, good or bad. However, there are opportunities beyond Canada and beyond cultivation.

Baron Lee, CFA
Portfolio Manager



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Our mailing address is:

350, 440 – 2nd Ave SW,
Calgary, Alberta T2P 5E9
Phone: 403.539.5740

www.matcofinancialinc.com