



MATCO MARKET INSIGHTS PODCAST SERIES: EPISODE 2

April 24, 2020

HIGHLIGHTS:

How the Cannabis Fund is currently positioned
Why the Fund experienced a large drop in net asset value in March
Outlook for the Cannabis industry

If you have any questions, comments, or suggestions about the podcast, please email:
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TRANSCRIPT:

Introduction

Welcome to the 2nd episode of the Matco Market Insights Podcast.

Anil → Hello everyone, I am Anil Tahiliani. Thank you for joining me today. We have a special podcast regarding the Matco Cannabis Fund. We hope everyone is staying safe and healthy during this Covid crisis. Joining me today is Baron Lee, the Lead Portfolio Manager of the Matco Cannabis Fund.

Baron → Hello everyone, thank you for joining us today.

Anil → For those who are not familiar with Matco or the Matco Cannabis Fund, Matco has been following the cannabis industry since 2014, investing in the cannabis industry since 2016 and launched one of the first cannabis funds in Canada in 2017. The Matco Cannabis Fund has been around for two years and we want to thank unitholders across Canada for your continued support.

Baron, over the past twelve months, investing in the cannabis industry has been very volatile. There has been a lot of negative news headlines, stocks have had major downward moves. Why are you still bullish on the sector today?

Baron → The past twelve months have been very challenging, but despite the recent volatility, we continue to be bullish. As an emerging industry, there will always be challenges, or what we call growing pains, but as the industry evolves and matures, the level of risk has decreased and the future looks promising. Our thesis hasn't changed and we continue to believe that cannabis is potentially one of the largest growth opportunities in our lifetime, to quantify this

- In 2018, global legal cannabis revenues totalled \$11 billion
- In 2019, revenues increased by 36% to \$15 billion
- And we expect revenues to reach \$250 to \$500 billion in a mature market
- To put that into perspective, in 2018, tobacco sales were approximately \$888 billion globally and alcohol sales were approximately \$1.3 trillion globally

Anil → We see the potential growth opportunity is \$15 billion today to \$250 to \$500 billion in a mature market. If industry revenues reach \$250 to \$500 billion, there appears to be significant upside for cannabis stocks. With that said, given that revenue grew by 36% over the last year for the industry why are most of these stocks down north of 50-80% .

Baron → Great question Anil, revenues have been growing and will continue to grow. Cannabis isn't new, we know that people consume cannabis, so we know that these revenues already exist. We are simply converting a black market into a legal market. And this conversion rate will accelerate and only accelerate when prices in the legal market are low enough to compete with prices in the black market.

Additionally, revenues from the medical and wellness channels will support revenue growth

However, revenue is just one of many factors to consider when making investment decisions. We believe investors are more concerned about profitability and balance sheets, as the industry has limited access to capital at the moment. Most cannabis companies have not reached profitability and many of these companies won't reach profitability if they don't have access to capital. Most cannabis companies have stretched their balance sheets, low cash levels and high debt levels. Without access to capital, a lot of these companies won't survive

Anil → Looking back about a year ago, I remember there was a lot of hype in the industry, daily news flow on BNN and newspapers talking about how well cannabis companies are doing. Given that the hype is now gone and the industry has transitioned from hype to fundamentals, how have you as a lead Portfolio Manager added value for our unitholders?

Baron → In 2018 and 2019, from a top down perspective, we executed two very important trades. One, we decreased the portfolio's exposure to cultivation and increased the portfolio's exposure to processing or what we call extraction. Two, we rotated out of Canada and into the U.S. By executing these two trades, we essentially eliminated the portfolio's exposure to Canadian licensed producers and invested in companies that were profitable and companies with strong balance sheets. For example and from a bottom up perspective, we increased our position in Valens, an extraction company, profitable and well capitalized, also the portfolio's largest holding and the best performing cannabis stock in 2019. We also increased our position in Curaleaf and initiated positions in Cresco, GTI and Trulieve, which are all U.S. multi state operators, all profitable and well capitalized.

Anil → It sounds like your active call was to be underweight Canadian licensed producers, overweight extraction and overweight U.S. multi state operators. Can you give us a breakdown in terms of how the Matco's portfolio is positioned in terms of geographical exposure, privates vs publics and maybe some sector exposure?

Baron → The portfolio is diversified through private and public companies, geographies, different segments of the cannabis value chain and in the supporting ancillary businesses. As of March 31, the portfolio had a 49% allocation to private companies and a 48% allocation to public companies. In terms of geography, 44% Canada, 51% U.S. and 3% international or in Colombia. It's important to note that within the 44% allocation to Canada, only 2% is allocated to licensed producers and the remaining 42% is allocated to extraction, retail and ancillary businesses. When we look at the value chain, we have 6% in cultivation, 29% in extraction, 8% in retail, 47% in U.S. multi state operators and 9% in ancillary businesses.

Anil → Sounds like the Matco Cannabis Fund is diversified geographically and by sector, but why was the fund down so much in March?

Baron → The portfolio was down approximately 25% in the month of March, for two reasons. First, global equity markets extended their losses from the previous month, as the coronavirus spread to over 180 countries, and cannabis stocks were not immune to this. Second, global equity markets entered a bear market, as such it was appropriate to reduce the valuation on six private companies and this has been reflected in the value of the portfolio as of March 31.

- Past valuations were predominantly based on recent transactions, however, these transactions have become stale
- So, current valuations are more inline with public company comparables, which means the net asset value of the portfolio will be more volatile going forward, as the valuation of these private companies are now pegged to public companies

Although the portfolio was down over 25% in the month of March, the portfolio has outperformed the HMMJ by over 23% since inception, on a cumulative basis. The HMMJ or the Horizons Marijuana Life Sciences Index is made up of publicly traded cannabis companies and is an ETF that tracks the North American Marijuana Index

Anil → In the last couple of commentaries you have written providing an update on the fund you've been talking about some private transactions in terms of takeovers happening in the fund. Can you give us an update on those given the current economic situation?

Baron → There are currently nine private companies in the portfolio and three of these companies have entered into definitive agreements to be acquired.

- 420 by High Park Holdings, a wholly owned subsidiary of Tilray
- Ample Organics by Akerna and
- Grassroots by Curaleaf



Although the Ample Organics and Grassroots transactions are expected to close in the second or third quarter of this year, 420 has been informed that Tilray is terminating the arrangement agreement, but does not believe there are valid grounds and is currently considering legal options. Regarding the other six private companies, we anticipate that they will provide liquidity at higher valuations over the next three years

Anil → Baron, when the fund was launched about 2 and a half years ago with the 5 year life in mind, what is your outlook for the remaining 3 years?

Baron → First, we believe the global economy will eventually recover from the coronavirus and investors will be rewarded with strong returns over the next economic cycle. The cannabis industry and cannabis stocks should follow a similar path. However, not all cannabis companies are the same. As you mentioned earlier, the cannabis industry is no longer trading on hype and is now trading on fundamentals. And fundamentals will separate the losers from the winners.

Second, although the recreational market will be much larger than the medical market, we believe that advancements in medical cannabis will be a primary driver for the industry going forward. We believe that cannabis is medicine, that clinical trials will support the efficacy of medical cannabis and that the stigma associated with cannabis will continue to fade. We believe that more and more countries around the world will legalize medical cannabis and, maybe one day, recreational cannabis. Today, there are over 50 countries that have legalized medical cannabis and 6 of these countries that have legalized recreational cannabis

Third, cannabis is an emerging industry, which explains the recent volatility. It's just entering the growth stage, with a long a runway ahead of it. Data will continue to support the legitimacy of the industry, and institutional investors will begin to pay attention. Institutional investors invest in fundamentals, while retail investors typically invest on hype. Institutions as an incremental buyer, will not only provide capital but they will also provide stability.

I want to remind unitholders of the Matco Cannabis Fund, that this is a legitimate industry with real companies generating real revenues and these revenues are expected to increase from \$15 billion today to over \$250 billion in a mature market, possibly one of the largest growth opportunities in our lifetime.

Anil → Baron just a side question, given that everyone is restricted on where we can go but the number of essential services such as liquor stores and cannabis stores are still open. Are cannabis stores seeing increased sales during this period of Covid?

Baron → Yes they are surprisingly. Most provinces and most states in North America have identified dispensaries or even producers and testing labs that we own as essential services. They have been

allowed too remain open and continue to sell cannabis. Sales have actually spiked in the month of March as people started hoarding as they expected dispensaries and production facilities to close down. Something else that is interesting and that we have been analyzing is that the Cannabis industry has a lot of similarities to the alcohol industry and alcohol is a very recession resilient industry.

Consumption of alcohol doesn't really change much, it's just that consumer preference changes so they will consume more low to mid priced products and consume less high products and we think that will play out in the Cannabis industry as well.

Anil → Baron, I've got one last question to wrap up our session today. For the last six to eight months we've been hearing about how capital markets meaning equity markets and debt markets are closed for Cannabis companies raising money. Are there any concerns about any of our portfolio holdings in the Matco Cannabis Fund that any of those companies can go bankrupt or need financing or be forced to restructure?

Baron → I would break this question into two parts. First we'll talk about the privates. A lot of these companies are pre revenues so they are not even generating revenue at the moment. A lot of them are just entering the commercialization stage, they are just about to start sales. These companies are under pressure because these companies have a difficult time in raising capital whether it's through debt or through equity. However we've communicated with these companies over the past three months very frequently and for the most part these companies have enough cash for the rest of 2020.

When we look at our public companies we talked about exiting Canadian licensed producers and rotating that into US MSOs. The reason for that trade was that the US MSOs are much more well capitalized and for example one of our largest holdings is Curaleaf. Curaleaf is a US multi state operator with production facilities in multiple states, with dispensaries in multiple states and they were able to raise over \$300 million dollars in debt in the month of January and this is significant because in the month of January and even over the past twelve months the cannabis industry has been capital constrained. We've seen many transactions or raises fail and we believe that going forward it's probably another six months out before we see additional capital enter the space.

Anil → Thank you Baron, we will wrap this up. I'd like to thank you for your time today and giving us a very informative update on the Matco Cannabis Fund. To our clients and listeners, if you have any additional questions regarding the Cannabis Fund, please reach out to your Matco portfolio manager by email or phone. On behalf of everyone at Matco Financial, we hope you and your family remain safe and healthy during these Covid times.



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