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Cannabis Industry Continues to Roll

The following article was originally published in our *2019 Canadian Capital Markets Report*.

Read the complete report.

The cannabis industry has been one of Canada's most talked-about sectors over the past 24 months, headlined by a handful of significant M&A transactions and cross-border investments. We expect cannabis will continue to make headlines in 2019 as cannabis issuers seek to develop next-generation products and implement international expansion strategies.

Proposed and actual liberalization of U.S. cannabis laws has led to increased appetite for exposure to the U.S. cannabis market, and investments by alcohol and tobacco players have legitimized a nascent industry. With these factors in mind, we expect to see the capital markets' "cannabis frenzy" continue throughout 2019.

United States Legalizes Hemp

On December 20, 2018, U.S. President Donald Trump signed into law the so-called Farm Bill (*Agriculture Improvement Act of 2018*), which removed industrial hemp from the definition of "marihuana" under the federal *Controlled Substances Act*. This action created a federally legal environment for the cultivation, distribution and sale of industrial hemp in the United States and made hemp an ordinary agricultural commodity. The significance of this enactment stems from the presence of the non-psychoactive cannabinoid, cannabidiol (CBD), which is found in industrial hemp and purported to have a range of therapeutic benefits. CBD derived from "marihuana" will continue to be federally illegal, and hemp-derived CBD will be subject to state regulation.

Canadian licensed cannabis producers Canopy Growth Corporation (Canopy) and Tilray Inc. (Tilray) have already sought to take advantage of the liberalized U.S. hemp laws. On December 17, 2018, Tilray announced that it had entered into a letter of intent to purchase hemp-derived CBD isolate from LiveWell Canada Inc., which will be sourced from both the United States and Canada and processed by Tilray for distribution in wellness and medical products across both countries. Canopy, meanwhile, has taken a step toward establishing a direct presence in the United States. On January 14, 2019, Canopy announced that it had been granted a licence by New York state to process and produce hemp. Canopy intends to invest US$100 million to US$150 million in large-scale production facilities dedicated to hemp extraction and product manufacturing within the United States. To facilitate its U.S. hemp endeavours, earlier this year Canopy announced the acquisition of AgriNextUSA, an organization noted as being at the forefront of hemp advocacy in the United States.

Although estimates of the potential market for hemp-derived CBD vary greatly, ranging from US$2 billion to US$22 billion, the consensus appears to be that a significant opportunity exists in the U.S. hemp-derived CBD market.

United States Moves Closer to Liberalizing Federal Cannabis Laws

On June 7, 2018, Senators Cory Gardner and Elizabeth Warren introduced the *Strengthening the Tenth Amendment Through Entrusting States* (STATES) *Act* in Congress, which would amend the *Controlled Substances Act* to exempt individuals and corporations from prosecution for federal cannabis offences if they comply with relevant state cannabis laws. However, the STATES Act would not remove cannabis as a Schedule I narcotic, meaning that cannabis would remain federally illegal. With this distinction in mind, it remains unclear what impact the STATES Act, if passed, may have on the willingness of U.S. stock exchanges and federally regulated banks to participate in the U.S. cannabis industry. Likely of more import to U.S. federally regulated banks is the *Secure and Fair Enforcement* (SAFE) *Banking Act*, the passage of which would allow banks to service cannabis companies that comply with state laws. Currently, federally regulated banks are prohibited from servicing cannabis companies because any funds would be considered proceeds of crime.

Due to the slow progress of the STATES Act in the House and Senate, on December 17, 2018, Senator Cory Gardner introduced an amendment to a broader criminal justice bill before the Senate that mirrored the language of the STATES Act. However, the amendment was not accepted. It remains unclear whether the STATES Act will be passed into law; however, many have speculated that liberalization of federal U.S. cannabis laws is merely a matter of time. The SAFE *Banking Act*, on the other hand, was approved by the U.S. House Financial Services Committee on March 28, 2019, and is under review by the House and Senate.

Canopy to Acquire U.S. Cannabis Company upon U.S. Federal Legalization

On April 18, 2019, Canopy announced that it had entered into a definitive agreement to acquire all of the shares of Acreage Holdings, Inc. (Acreage), the largest vertically integrated, multi-state owner of cannabis licences and assets in the United States. Under the terms of the transaction, Canopy will pay a US$300-million upfront premium to certain classes of Acreage shareholders in exchange for an option to acquire all of the outstanding shares of Acreage.

Canopy's call option has a term of 90 months from the date of issuance. Canopy will be required to exercise the call option once the U.S. federal laws change to permit the general cultivation, distribution and possession of cannabis or to remove regulation of these activities from the U.S. federal laws. Upon exercise of the call option, each Acreage share will be exchanged for 0.5818 of a common share of Canopy, for total consideration (including the upfront premium described above) to Acreage shareholders of US$3.4 billion, representing a 41.7% premium over the 30-day VWAP of Acreage shares on the Canadian Securities Exchange (CSE) ending April 16, 2019.

The transaction represents the first outright acquisition of a U.S. cultivator by a TSX-listed Canadian licensed producer and gives Canopy immediate access to the U.S. cannabis market upon federal legalization. The deal is not without its critics, however, as Marcato Capital Management LP (Marcato), a 2.7% holder of Acreage shares, announced its intention to vote against the proposed transaction, citing, among other things, an insufficient premium that undervalues the potential value of Acreage upon federal legalization of cannabis in the United States. By the time Marcato announced its intention, Canopy's shares had risen 15.2%, while Acreage's share price had dropped 6% since the deal was announced. Acreage shareholders will vote on the proposed transaction on June 19, 2019.

Restructuring and Spinout Transactions Gain Popularity as Appetite for U.S. Exposure Increases

As a result of the TSX and TSXV policy prohibiting listed issuers from engaging or investing in activities that violate U.S. federal law, listed cannabis issuers have structured creative transactions to retain exposure to what many expect to be a lucrative U.S. cannabis market while remaining compliant with exchange listing requirements.

For example, in spring 2018, Aurora Cannabis Inc. (Aurora) spun out its U.S. assets in a new company, Australis Capital Inc. (Australis), which listed on the CSE. The CSE has adopted a disclosure-based approach to U.S. cannabis investments or activities and will permit listed issuers to engage in such activities. Aurora retained a back-in right to reacquire an interest in Australis upon the legalization of cannabis at the U.S. federal level.

Similarly, in October 2018, Canopy and Canopy Rivers Inc. (Canopy Rivers), the venture capital arm of Canopy, restructured their respective investments in TerrAscend Corp. (TerrAscend), a CSE-listed cannabis company, so that TerrAscend could pursue opportunities in the United States. By way of plan of arrangement, Canopy Rivers and Canopy exchanged their common shares and warrants in TerrAscend for non-participating, non-voting exchangeable shares that may be exchanged for common shares only on the federal legalization of cannabis in the United States.

U.S. Cannabis Issuers Flood North

Although regulated by many U.S. states, cannabis remains federally illegal in the United States; accordingly, no pure play U.S. cannabis companies will be found listed on federally regulated major U.S. stock exchanges. However, the disclosure-based approach of Canada's more junior exchanges, such as the CSE and NEO, has resulted in an influx of U.S. cannabis issuers listing north of the border. As of the date of this writing, 160 cannabis-related issuers list on the CSE alone, many of which have exposure to the U.S. cannabis industry.

Canadian Cannabis Companies Begin Listing on Nasdaq and NYSE

As noted above, U.S. cannabis companies are prohibited from listing on major U.S. stock exchanges. However, Nasdaq and the NYSE have accepted listings from Canadian cannabis companies that operate exclusively in Canada and other jurisdictions where cannabis is legal for medical and/or recreational purposes.

Cronos Group Inc. (Cronos) became the first U.S.-listed Canadian cannabis company – listing on Nasdaq in February 2018. Tilray completed its IPO on Nasdaq shortly thereafter in July 2018, bypassing a Canadian stock exchange listing altogether.

Canopy became the first Canadian cannabis company to list on the NYSE in May 2018, but has since been joined by Aurora, Aphria Inc. (Aphria) and CannTrust Holdings Inc. HEXO Corp. (HEXO), which has a market cap of approximately $1.3 billion, was approved for listing on the NYSE American on January 17, 2019.

Big Tobacco Arrives on the Scene

In March 2019, Altria Group Inc. (Altria), one of the world's largest producers and marketers of tobacco products, made an investment of approximately $2.4 billion in Cronos by way of private placement. Altria acquired both common shares, which represent an approximate 45% ownership interest in Cronos, and warrants, which, if exercised, would result in Altria owning some 55% of Cronos.

Just two weeks after the announcement of its investment in Cronos in December 2018, Altria announced a US$12.8-billion investment in Juul Labs (Juul), the dominant player in the e-cigarette space.

Altria's investment in Cronos marks the first major investment by a tobacco company in the Canadian cannabis industry and, coupled with its investment in Juul, a significant bet on the growing "vape" product category.

Alcohol Players Continue to Invest in Cannabis

The Cronos/Altria deal was structured in a similar fashion to the largest investment in the Canadian cannabis space to date: Constellation Brands' (Constellation's) $5-billion investment in Canopy. After investing $245 million for a 9.9% interest in Canopy in 2017, Constellation injected an additional $5 billion into Canopy in summer 2018, to bring its ownership to approximately 38%. Constellation also acquired warrants that, if exercised, would bring its position in Canopy above 50%.

However, Constellation is not the only alcohol player entering the cannabis space. In August 2018, Molson-Coors Canada and HEXO announced a joint venture under the name Truss to develop non-alcoholic, cannabis-infused beverages for the Canadian market. Molson-Coors Canada has a 57.5% controlling interest in Truss, with HEXO having the remaining ownership interest. In December 2018, Anheuser-Busch InBev, the world's largest brewer, announced a partnership with Tilray to research non-alcoholic beverages containing THC and CBD. Each party intends to invest up to $50 million in research, with the objective of having beverages ready for sale when they become legal in 2019.

Shoppers Drug Mart Receives Cannabis Sales Licence

On December 8, 2018, Shoppers Drug Mart (Shoppers) was granted a licence by Health Canada to sell medical cannabis online. According to Shoppers' website, it is currently servicing customers in Ontario only. Shoppers has indicated that it has no intention of producing cannabis and has disclosed that it has entered into supply agreements with a number of licensed cannabis producers, including Tilray, Aurora, Aphria, Emblem Corp., WeedMD Inc., The Flowr Corporation and Starseed Medical Inc.

Edibles Regulations Are on the Horizon

On December 20, 2018, Health Canada released draft regulations governing cannabis edibles, extracts and topicals, which are expected to come into force on or before October 17, 2019. The draft regulations were subject to a 60-day consultation period.

The draft regulations prescribe maximum THC and CBD limits for edible or topical products and require that such products be packaged in plain packaging, similar to that required for currently legal forms of cannabis. The draft regulations also prohibit certain forms or types of edible products. For example, the draft regulations prohibit (i) edibles that require refrigeration or freezing; (ii) extracts that contain added sugars, sweeteners or sweetening agents; (iii) packaging and labelling of cannabis extracts that list flavours that appeal to youth; and (iv) the use of non-dried meat, poultry and fish.

Although the consultation period has ended, it remains to be seen what the final draft of the regulations on edibles, extracts and concentrates will look like. One area that generated a significant amount of commentary during the consultation period was the proposed rule that regular food products and edible cannabis products could not be produced in the same facility. The capital cost associated with establishing a separate facility may limit the ability of existing food processors to participate in the industry. Additionally, the draft regulations also prohibit representations on cannabis product packages that would associate the cannabis product with an alcoholic beverage, suggesting that existing alcohol companies will not be permitted to utilize their brands in the cannabis space.

While much of the media focus has been on the participation of alcohol companies, it remains to be seen whether traditional consumer packaged goods (CPG) manufacturers will enter the edibles space. In November 2018, Canadian licensed producer Newstrike Brands Ltd. announced that it had entered into a joint venture with Neal Brothers Inc., a Canadian specialty foods company, to develop edible cannabis products. Although Coca-Cola had been rumoured to be investigating opportunities in the Canadian cannabis industry in early 2018, those rumours have not resurfaced since and no major CPG or confectionery players have been linked to the Canadian cannabis space. This is an area we will be keeping an eye on in 2019.

Short Seller Reports Permeate Cannabis Industry

Amid rising valuations premised primarily on perceived potential and production capacity, the cannabis industry has been a prime target for short sellers. In the last 12 months, Canadian cannabis producers Aphria, Cronos, Tilray, Aurora and Namaste Technologies Inc. have each been the subject of short-seller reports citing valuation issues ranging from deficient disclosure to improper accounting measures and insider dealing.

While the short-seller reports have generally resulted in only a temporary dip in the subject's share price, a report published by *The Globe and Mail* on January 23, 2019, indicates that cannabis companies remain some of the most shorted stocks, with Aurora, Aphria and Canopy ranking in the top 20 by percentage of shares on loan as of January 21, 2019.

Aphria Comes Under Fire and Faces Takeover Bid

Arguably the most talked-about short-seller report, published by Hindenburg Research and Quintessential Capital Management on December 3, 2018, targeted Aphria and alleged that a recent series of Latin American and Jamaican acquisitions, totalling approximately $425 million, were the product of insider dealing and involved the purchase of assets that were largely worthless. Aphria's share price fell nearly 30% in the wake of the report from its pre-report share price of $10.51, but has since rebounded to $11.50 per share as of April 15, 2019.

On January 11, 2019, Aphria announced that Vic Neufeld, the company's CEO, and Cole Cacciavillani, the company's co-founder and VP of Growing Operations, would be stepping down from their roles. Subsequently, on January 23, 2019, Green Growth Brands (Green Growth) launched a takeover bid for Aphria after publicly announcing its intention to do so on December 27, 2018.

The Green Growth bid contemplated an all-share transaction valued at $2.8 billion. However, the value ascribed by Green Growth was premised on a $7 per share price of Green Growth stock, despite Green Growth having never traded above $6.20 on the CSE and closing at a price of $5.81 on the day it announced its bid. Green Growth had previously announced that it would complete a $300-million financing at $7 per share to lend credibility to its valuation; however, it was announced that half of such financing would be purchased by a related party of Green Growth. On April 15, 2019, Green Growth and Aphria came to terms, resulting in an early termination of Green Growth's hostile bid, a mutual 12-month standstill period and an agreement to enter into discussions involving potential commercial arrangements.

Big Banks Continue to Get Comfortable with Cannabis

The major Canadian banks have been slow to enter the cannabis space, though recent activity has evidenced increased comfort for some. BMO Capital Markets has been the leader in the space, having co-led bought deal financings for Canopy, Cronos and Auxly Cannabis Group Inc. (then Cannabis Wheaton Income Corp.) in early 2018 and providing a $200-million credit facility to Aurora in June 2018.

CIBC Capital Markets entered the fray in the summer of 2018, acting as agent on a private placement for Canopy Rivers in connection with its reverse takeover listing on the TSXV and underwriting a $63.5-million bought deal for Canopy Rivers in February 2019. On January 7, 2019, BMO (as lead lender), CIBC and Concerta Bank agreed to provide up to $80 million in secured financing to PharmHouse Inc., a joint venture in which Canopy Rivers is a partner. Subsequently, BMO and CIBC teamed up again to offer a $65-million secured term loan to Cronos Group and a $65-million secured term loan to HEXO.

We expect to see the other major Canadian banks enter this space as the Canadian cannabis industry continues to mature. Scotiabank acted as financial adviser to Aphria in the unsolicited takeover bid by Green Growth Brands. Meanwhile, on March 19, 2019, RBC entered into a construction loan facility with Eve & Co Incorporated in the amount of $18.7 million to fund the construction of a cannabis greenhouse.

Changes to *Cannabis Act* Licensing Process

On May 8, 2019, Health Canada announced significant changes to its policies for the review of cultivation, processing and medical sales licence applications under the *Cannabis Act*. Such applications will only be considered for licensing if the applicant has in place “fully built” facilities that comply with all regulatory requirements.

Previously, cannabis licensing applicants were able to advance their applications and obtain some level of comfort regarding licensing before spending capital on production facilities. Many applicants have been able to raise substantial capital for build-out purposes on the basis of a pending licence. We expect Health Canada’s new approach will mark a turning point in the development and maturity of Canada’s cannabis ecosystem, including capital markets activity. The change will benefit well-capitalized issuers that are prepared to invest in the development of regulatory-compliant facilities without any licensing assurance from Health Canada. We also expect it will divert investment capital to issuers that have a demonstrated track record of building and licensing facilities. Whether this change alleviates supply shortages and wait times for existing applicants that are ready or nearly ready to begin commercial operation remains to be seen.

What’s in Store

Looking forward, we expect to see Canadian cannabis issuers continuing to actively deploy capital, with the focus shifting from expanding domestic production capacity to gaining exposure to the U.S. market and developing next-generation products, such as edibles and vapes. Furthermore, on the heels of the investments by Constellation and Altria and with the regulation of edibles expected to come into force in the fall, we will be watching to see if a major consumer packaged goods player enters the Canadian cannabis space.

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