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**Value drivers in a dynamic
cannabis market**



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In a fast-evolving market, we look at how investors and producers can harness value in the medical and recreational market in Canada

The Canadian cannabis industry is growing up. We're seeing the industry change from one where promises, hopes, and speculation were the driving force of growth, to one where strong business fundamentals, financial acumen, and management experience determine a company's prospects. While some have sounded the alarm on the industry, our view is that the market is evolving, creating opportunities for investors who have well-researched and innovative strategies to build value and drive growth.

While many headlines may paint a gloomy picture of the cannabis industry, we continue to observe that there are resilient key players in the market. The challenge in this market today, even for seasoned investors, is to identify and analyze the value drivers of a cannabis business and their link to sales growth, profitability, and risk. While industry analysts continue to predict significant long-term revenue potential, it's not always immediately apparent which types of companies will see the greatest gains.

To answer the complex question of what drives value in today's cannabis organizations, we analyzed multiple data sets from more than 40 listed companies over two years. We then combined this data with key takeaways from companies that have been effective in the market in the weeks and months since. The results of our analysis helped us develop a framework for identifying and analyzing value in the two channels of cannabis distribution: medical and recreational.

The medical cannabis market: delivering value for investors and producers alike

Producers have much to gain in the medical market, which is not subject to the same restrictive regulatory environment as the recreational market. Higher prices for medical cannabis mean higher net value, and not being subject to restrictions on the transborder shipment of drugs opens up significant potential for global trade. There's also potential for medical reimbursement from public and private insurers, and a lower fiscal burden compared to the recreational market. Finally, medical products don't have the same need for expensive investments in brand development, which makes marketing cost-effective.

The promising growth fundamentals of the medical market can be maximized by strong relationships between regulators, producers, and investors, and lay a strong foundation for future growth. Looking at investor relations in particular, companies need to attract stable, institutional investors rather than the more fickle retail investors if they want to achieve sustained growth.

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The challenge of current scientific research

To understand the mindset of the institutional investor, it's crucial to understand the risks as well as the rewards of medical cannabis. Despite the buzz around the medical benefits of cannabis, there is a dearth of double blind, placebo-controlled studies to provide empirical evidence to confirm the effectiveness of THC or CBD for the treatment of medical issues beyond a few rare disorders.

There have been exciting findings on the use of THC as a treatment for patients suffering from spasticity associated with multiple sclerosis and severe epileptic seizures in Dravet syndrome, but neither of these benefits, although encouraging, generate mass market appeal.¹ There have been positive preliminary studies linking cannabis with the alleviation of chronic pain and muscle stiffness stemming from conditions such as Parkinson's, fibromyalgia, endometriosis, interstitial cystitis, and even post-traumatic stress disorder. Other studies show that cannabis can also help increase appetite in patients suffering from Crohn's disease or HIV, and increase quality of life in palliative care.² At the same time, a number of reports also show a correlation between cannabis use and psychosis, and the onset of disorders such as schizophrenia and bipolar disorder.³

Finally, we're still not sure how cannabis consumption affects the endocannabinoid system, which was only discovered in 1992. Endocannabinoids are naturally occurring "cannabis-like" molecules that operate throughout the brain and central nervous system and help regulate appetite, pain, memory, and

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muscle function. There is growing scientific interest around the potential of cannabis to address issues occurring within this network of neurotransmitters, proteins, and receptors, but we have limited current knowledge of the effects of cannabis on it.⁴

All in all, considering the history and prevalence of its use, cannabis is a remarkably under-researched drug. Coupled with this fact are the complexities surrounding medicalizing any psychoactive substance—if you had to abstain from driving for four hours every time you took a Tylenol, would acetaminophen be a billion-dollar product class?

The value of intellectual property rights

The shortcomings in the scientific literature on cannabis mean that intellectual property (IP) rights, underpinned by comprehensive clinical trial plans, are a critical value driver. Patents give their owners the ability to compete unimpeded by alternative suppliers, allowing them to recoup the costs of high-quality research and development. The barrier to entry they create gives companies time to build a foundation for profit and the ability to compete with future products. Progress in research and development (R&D) creates data and knowledge that can set companies apart in the eyes of investors. It's for this reason that IP is so valuable, and why, as the pace of new studies and new research begins to intensify, it will be more important than ever. Medical cannabis producers should recognize that securing patents will make or break their businesses and that they need to be proactive in gathering and protecting their IP.

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Demonstrating clear results through comprehensive double-blind studies builds the legitimacy of an organization and its products

Underscoring quality to attract investment

Being able to make a strong case for the medical value of a drug, with the necessary R&D evidence to back up any claims, is the right way to catch the attention of institutional investors. Sophisticated investors, especially those specializing in pharmaceuticals, analyze the strength of a company's board and leadership, strategy, and market trends, but they also focus on the quality of the product. Demonstrating clear results through comprehensive double-blind studies builds the legitimacy of an organization and its products, and opens doors to future investment opportunities. We saw this with the UK-based firm GW Pharmaceuticals, whose research helped secure a landmark FDA approval for the use of its cannabis-based drug, Epidiolex, to treat the Lennox-Gastaut and Dravet syndromes,⁵ two rare epileptic disorders.

Once thorough R&D practices are in place and patents are secured, it becomes a matter of effectively communicating this value to attract a stable investor base.

The recreational cannabis market: Competing on the newest frontier

Competitive pricing that maximizes margins

With continuing competition from the illicit market, optimizing the supply chain and finding a price point to justify the purchase of legal cannabis by consumers is critical. In other cases where markets had to overcome illegal competition—whether through bathtub gin, bootlegged DVDs, or downloaded MP3s—the turning point was often the moment it became more convenient for consumers to swallow the additional cost than to contend with the complication and risk of operating outside the legal market. This is evidenced by today's music and video streaming services that operate on a monthly-subscription basis. But with cannabis, there are limits to how low prices can go. "Whether it's excise tax or explicit value-added tax, the costs of compliance, or the regulatory burdens at each step of the supply chain, legal product will always be more expensive," explains one Wall Street analyst. Government-initiated costs will factor into the final price; there's no way around it.

But as the market matures and the government shifts focus from ensuring compliance with new regulations in the legal market back to cracking down on the illegal market, competition will begin to recede.^{6, 7, 8} Leaders in the cannabis market continue to develop the strength and efficiency of their supply chains. "As the sector evolves and innovates, I think you'll see the value proposition to all customers along the regulated supply chain increase, and as a result, companies will overcome the hurdle of government-induced costs," says Bill Stamatis, a partner in Deloitte's cannabis practice.

With cannabis, there are limits to how low prices can go

8 5. Goldschmidt, Debra. "FDA approves first cannabis-based drug." CNN, July 2018.
6. "City of Toronto ramps up fight to close illegal cannabis stores." The Canadian Press, July 2019.

7. "City will use 'aggressive enforcement' to shut down illegal pot shops, official warns." CBC, April 2019.
8. Smyth, Mike. "B.C. government's pop squad targets illegal cannabis shops." Postmedia, December 2019.

Attracting new customers continues to be the clearest path to growth

This may be the case once the market matures, but for the time being, our research shows that attracting new customers continues to be the clearest path to growth.⁹ The existing consumer knows how low cannabis prices can be and is not the target customer, as such consumers often have an existing (illegal) supply chain: their dealer. New users, on the other hand, place a higher value on safety, as well as on brand reputation, which benefits the legal cannabis market.¹⁰

Efforts like those taken by Shoppers Drug Mart and TruTrace to ensure traceability in the cannabis value chain represent an important step in legitimizing the industry. Programs like these inspire confidence in both institutional investors and consumers, and should be adopted by recreational cannabis players everywhere.

The importance of branding, promotion, and marketing

Current regulations limit product branding, promotion, marketing, and even store ownership in the recreational cannabis market, but this doesn't have to limit a company's ability to thrive. We can use Canopy Growth as a case study for optimizing marketing potential within the current regulatory framework.

Canopy Growth's subsidiary, Tokyo Smoke, began establishing its presence in the market years before the legalization of cannabis. Its leaders saw the opportunity to market to young professionals with stylish merchandise and cannabis-adjacent products ranging from pens to pipes.¹¹ By playing the long game and targeting image-conscious consumers, it was able to make key gains where other companies

struggled to keep up. While the illegal market currently has an unregulated product with low overheads and decades spent mastering the supply chain, companies like Tokyo Smoke have been able to carve out a demographic by selling products that stand out from a brand and style point of view.

Elevating the experience

Quality is not limited to the drug itself. It can be an entire holistic experience: entering an attractive, bright store, receiving informative and friendly customer service, and leaving with goods carefully wrapped in an attractive package. These are all elements the legal recreational market alone can offer.

The recreational market also benefits from IP rights and patenting, in everything from new strains to branding and quality initiatives, especially in unique cannabis-adjacent product design. These patents will serve to grow value not just in the eyes of consumers but with investors—stable institutional investment interest is just as important in the recreational channel.

Investors will also take note of organizational reputation and public interest. While product branding may have to remain limited, corporate branding does not. There is enormous potential for companies to build loyalty within the constraints of the current market and build name recognition. Brand awareness is essential, especially for consumers unfamiliar with cannabis, where establishing trust is key.

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"We're seeing corporate branding taking centre stage, which isn't product-specific branding, but has a halo effect on the product's brand," says a Deloitte cannabis expert.

Depending on how government regulation evolves, the recreational cannabis market could end up being analogous to any other controlled-product market. And like alcohol and tobacco, having a brand built on the right design, tone, and celebrity endorsement would represent significant growth opportunities.^{12, 13}

Toward a post-hype cannabis market

While there is some pessimism about today's market, there is still a great deal that investors and producers can learn from the experience accumulated to date. We can strategize based on data, emerging medical research, and conversations with industry experts and stakeholders. We can study organizations that have been successful in challenging conditions to emulate their performance and adopt best practices. Most importantly, we can focus on simple, universally effective business fundamentals: managing risks and costs, understanding the needs of customers, and clear planning and goal execution.

The volatility facing companies today will test the overall resilience of their leaders, and their ability to drive value and establish a strong business model. But by building on what we know about the market and about this industry, leaders can still move forward despite uncertainty.

The globalization of cannabis is inevitable. The question will be, which leaders are capable of rising to the challenge and making the most of available

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opportunities. Cannabis companies that are able to professionalize and establish brand recognition as legitimate, trustworthy players in the market are those that will survive and grow in the long term. Regardless of whether they operate in the medical or the recreational segment, organizations will need to implement smart planning in key business areas to build value and thrive in this burgeoning new market.

In some ways, today's market turbulence can be seen as positive because it signals a turning point in industry maturity. As the hype around cannabis is replaced with realism and a return to business fundamentals, investors and cannabis producers who've done their homework and proven their agility and resilience stand to reap the benefits.

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