



Ninepoint Alternative Health Fund

September 2018 Commentary

The cannabis sector continued to gain traction in September as investors anticipated the potential investments from strategic investors from the alcohol/spirits industry. Since mid-August, when Constellation Brands (STZ:NYSE) invested \$5 billion in Canopy Growth (WEED:TSX, CGC:NYSE), the sector is focused on who will be next. That speculation, combined with interest from retail US investors has driven valuations higher during the month, and raised questions about the sustainability of the valuations within the sector.

Not all companies are treated equally though and not all companies should be valued with the same valuation metrics. Making this determination is what active management is charged with doing. We do due diligence and seek to build our own valuation models, eliminating media and speculation from our investment decisions. It is important to note that the average valuation based on 2020 EBITDA for Canadian cannabis companies is 20 times (at time of writing). There are four outliers that have significantly higher valuations: one at 156 times one at 90 times, one at 41 times and one at 40 times.

Given the focus on valuations, we thought it would be useful to look at other industries and other companies that have large addressable markets, with significant growth opportunities and yet the companies have no current earnings. There are many public companies trading at higher valuations than the Canadian cannabis LP's. Companies that have no current earnings but trade at high multiples of 2020 EBITDA estimates include Wayfair (W:NYSE), Dexcom (DXCM:O), Shopify (SHOP:TSX), Square (SQ:NYSE), Autodesk (ADSK:O). There are 42 companies in North America (excluding the cannabis sector) that have a market cap higher than \$3b with no trailing or current EBITDA (earnings before interest, taxes, depreciation). The average valuation of these companies is 67x 2020 EBITDA. This isn't to say we agree with all company valuations and that we should buy all the names in the sector, but it is illustrating that there is precedence for unique opportunities to attract premium valuations. Again within the cannabis sector, it requires active management to do the due diligence required to determine which teams to invest in.

There have been some interesting industry developments this past month that we believe are worth highlighting;

- Shoppers Drug Mart (L-TSX) has received Health Canada's approval to be a licensed producer and distributor of cannabis medication, opening the door for the pharmacy giant to dispense medical cannabis to patients. We anticipate similar announcements from the major pharmacy chains throughout Canada in the coming weeks and months.
- Aphria Inc. (APH:TSX) announced that it had entered into a wholesale supply agreement with

Investment Team



Charles Taerk,
President & Chief Executive
Officer, Faircourt Asset
Management - Sub-Advisor



**Douglas Waterson, CA,
CFA**
Chief Financial Officer &
Portfolio Manager, Faircourt
Asset Management - Sub-Advisor

Emblem Cannabis Corp. to supply 75,000 kg of high-quality cannabis over a five-year period starting May 2019. As part of the agreement, APH is receiving a non-refundable deposit of \$22.8 million, and 6.9 million common shares of Emblem. For Emblem (EMC:CVE), it provides necessary supply for extracts that will allow EMC to deliver on its supply agreements. For APH, it demonstrates the demand for its expanded production capabilities as its Phase IV greenhouse at the Aphria I facility comes on stream, bringing total annual capacity to over 100,000 kg. At this level, APH is the second largest producer in Canada, behind WEED at current annual capacity of XXX,XXX.

- Another supply agreement between Canadian LP's was announced in September as Supreme Cannabis (FIRE:CVE), entered into supply agreements to provide dried cannabis to Tilray Inc. (TLRY-O). The value of the supply agreements are estimated to be in excess of C\$12 million and we understand that the terms of the supply agreement were quite favourable to FIRE. The dried cannabis will be part of the supply TLRY distributes to its medical cannabis patients in Canada.
- During the month, Aurora Cannabis (ACB:TSX) announced its intention to enter the South American market, with a population of 420 million people, through its acquisition of ICC Labs Inc. ACB will acquire all of the issued and outstanding common shares of ICC Labs Inc. (ICC-CVE) for \$1.95 per share in exchange for shares of ACB, total consideration of \$290 million. Currently, ICC controls 70% of the medical cannabis market in Uruguay. Other Canadian LP's already present in South America include APH, through its Colcanna SAS and its recently acquired ABP SA that distributes to pharmacies in Argentina and Canopy Growth (WEED) that established a cultivation and distribution business in July, when it acquired Colombian Cannabis S.A.S.

The subject of multi-jurisdictional listings is also becoming a topic of conversation. Several Canadian companies are interested in exploring NASDAQ and NYSE listings after the success of Cronos, the first Canadian NASDAQ listed LP; Canopy the first NYSE listed LP and TLRY, the first Canadian LP to complete an IPO and list on NASDAQ. We understand that companies such as APH, ACB, CannTrust (TRST:TSX), Organigram (OGI:CVE) among others are reviewing operations, becoming Sarbanes-Oxley (SOX) compliant and looking to entertain a listing on the NASDAQ before year end.

TLRY announced in September that the U.S. Drug Enforcement Administration (DEA) granted approval to TLRY to import a cannabinoid study drug into the United States from Canada for a clinical trial at the University of California San Diego (UC San Diego) at the Center for Medicinal Cannabis Research (CMCR) examining its safety, tolerability and efficacy for Essential Tremor (ET). Essential Tremor is a neurological movement disorder characterized by involuntary and rhythmic shaking. In the trials, TLRY is providing a capsule format, which will allow researchers to test both an investigational drug and a new delivery format, a solid capsule. Allowing cannabis to be imported is an important development in the US, as it could signal a softening of the legal environment.

Further solidifying the medical cannabis market in several states is a push to reduce opioid usage among chronic pain patients. Under a new law signed by the Governor of Illinois, doctors now can prescribe medical marijuana to patients who already have qualified for prescription opioid drugs such as OxyContin or Percocet. Technically, the bill amends the state's Compassionate Use of Medical Cannabis Pilot Program Act. Those who wish to use medical marijuana to replace opioids will not have to go through the process of getting fingerprinted or waiting on a background check. The bill also provides authorities the right to wave criminal marijuana charges against a "cultivation

center agent, dispensing organization, qualifying patient, or designated caregiver” if the person can prove they violated the law as “the result of opioid addiction or dependence.” The law officially begins in December and we believe will be meaningful to sales. A similar law was subsequently passed in NY.

New clinical trials are also taking place in Canada, as TRST announced that it is partnering with McMaster University on medicinal cannabis research at the Michael G. DeGroote Institute for Pain Research and Care at McMaster University on a range of upcoming randomized placebo controlled clinical trials (RCT) involved in the treatment of chronic pain.

Also of note in the US, is a major step in the consumer products category, with Origin, an Estée Lauder (EL:NYSE) product line, launching a new face mask called 'Hello, Calm' exclusively on the Sephora website. EL joins several other cosmetic brands that started selling hemp based CBD products, signalling the increasingly mainstream status of CBD derived products.

We believe that the long-term opportunity in the health and wellness and medical cannabis industry is an ever increasing global market. Currently, close to 40 countries have some form of cannabis legalization and the addressable market within that population base is over 1.2 billion people. Focus outside of Canada will be important for the Canadian LP's to continue to grow profitably.

The European Parliament is currently working on a draft proposal on medical cannabis to harmonize laws within the European Union. In France, a French health agency has launched a temporary scientific committee to assess how to create a medical cannabis market in France. The nation legalized cannabis-based medicines in 2013, but no product is legally available because the market has not been developed. The committee will assess the feasibility of creating a market, which medical conditions it should be allowed for and how such a market would be accessed. As we get close to 2019, Germany has announced its intention to award the country's first domestic licenses for medical cannabis cultivation in the first quarter of next year, with the first crop expected in 2020. The country is on track to become one of the world's largest medical marijuana markets where patients are covered through medical insurance and we are excited by the potential for the German market.

With volatility for the sector reaching as high as 150%, we saw an opportunity to add an options writing overlay to the fund's portfolio management. As a result we are now writing cash secured puts on specific names we would like to own in the Fund but whose securities are trading at higher prices. Cash covered puts are often being written out of the money at strike prices that we believe are closer to values that better represent our belief in the companies. Therefore, on expiration date, if the position is trading above the strike price and sentiment towards the underlying remains unchanged, the cash covered puts that were sold will expire worthless. This allows us to pocket the above average premiums received and continue writing more put options. Should the stock price fall but our sentiment not changed we will be able to buy the stock at a reasonable discount less the premiums received from the sale of the put options. The cost base of our stock purchase will be the strike price less the premium received. If a significant piece of bad news had surfaced which negatively impacted the fundamentals of the stock causing our outlook to change we have the option to close out our position at a loss. It is important to note any loss realized would be far less had we taken a long position when the option trade was first entered into. Below is an example of a put writing trade we entered into this month.

On September 20th APH was trading at \$18.93 and we wrote a one week cash covered put by selling a Sept 28th expiry at the volatility level of 124 with strike price \$17.50 and earning \$ 0.75. That equates to a strike yield of 4.3% for 7 days or the equivalent of 200% for a year. The breakeven for being assigned would have been \$16.75 or 11.7% lower than the reference point when the trade was placed. On the September 28th APH closed trading out of the money at \$18.00 and the put option expired worthless. Our profit is therefore equal to the amount received for selling the put option which was \$0.75 per share.

At a time when there is a significant amount of change and the sector doesn't have widely distributed research, we believe that the best way to invest in the sector is through an actively managed fund. We are able to reduce risk through due diligence, reduce volatility through our portfolio allocation and invest in companies that are not as well-known as others but have strong leadership positions in the markets in which they operate.

Until next month,

The Alternative Health Fund Team

Compounded Returns¹

	1MTH	YTD	3MTH	6MTH	1YR	INCEPTION
FUND	12.3	43.9	31.4	50.0	108.4	93.2
INDEX	6.3	30.3	21.2	37.5	77.3	64.4

¹ All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at September 30, 2018. The index is 70% Thomson Reuters Canada Health Care Total Return Index and 30% Thomson Reuters United States Healthcare Total Return Index and is computed by Ninepoint Partners LP based on publicly available index information.

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Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: RBC Investor & Treasury Services: Tel: 416.955.5885; Toll Free: 1.877.874.0899