

Whistling Past the Marijuana Graveyard



The marijuana community in Canada is enjoying a huge surge in value, driven by the federal government's looser medical regulations and the dream of decriminalization. Analysts and market participants are predicting that surge will hold and that values will increase even further "when decrim happens".

There are conflicting and unreliable estimates of the number of Canadian authorized users. My experience in the marijuana industry and my own research gives me a best guesstimate of 60,000, out of a population of 35 million. That means the current legal market is about 0.15% of the Canadian population. That market is far too small to justify the current valuations enjoyed by the marijuana companies.

Since the current market is too small, it's obvious investors are counting on future cash flows from the larger but as-yet-illegal recreational market. What happens to those lofty valuations if decrim doesn't happen?

First, some context is needed. In August of 2015, we compared the gyrations of the marijuana market to the dotcom's boom / bust / slow rebound. At that time, the Marijuana Index had fallen roughly 90% over the prior 2 years to a low of around 310. At the time we said:

"Hemp and marijuana companies are currently in a bust phase of a longer cycle. This doesn't mean their business plans are flawed (although some are) nor does it mean management is making mistakes (although, again, some are). It means the regular cycles of capitalism are doing their job, just like during the internet era. After the bust will come an echo."

That echo is coming to us now, on cue, with that same marijuana index having clawed its way back to 460 in a little over a year. The bulk of that rise has taken place since August.

The small target market is only one of the risks inherent in this industry. Also, note that two of Canada's largest banks are backing out of the marijuana industry altogether, closing accounts for companies related to the industry. For the banks, this is a risk management approach, without regard for the growing social acceptance of self-medication.

And as much as the industry wants to downplay it, organized crime is lurking around the edges of the marijuana growers. At a licenced operation in the Niagara Region in Ontario, police arrested 18 people for illegally overproducing marijuana and not accounting for it in the company's records. After those arrests, police said the extra illegally grown marijuana wasn't being used for medical purposes, but was suspected of being sold "on the black market for financial gain."

But investors seem to be comfortable with those known risks within the legal framework.

Here, the law and medicine are working together to build that framework. It is a medical fact that marijuana has psychotropic effects. That's why people are using it to self-medicate! All use of marijuana in Canada is governed by the *Controlled Drugs and Substances Act*, and that means that all use of marijuana is illegal, whether for recreational or medical purposes, unless under a doctor's authorization and obtained in accordance with the law.

The current government (the Liberals, under The Right Hon. Justin Trudeau) made the decriminalization of marijuana a campaign promise in last October's federal election. That promise dovetailed with recent court decisions (*Smith, Allard*) that liberalized patient rights.

In mid-August, to comply with the court decisions, the federal government introduced new regulations governing medical marijuana in Canada. These rules are called the "Access to Cannabis for Medical Purposes Regulations" or ACMPR.

The ACMPR allows for more of a decentralized system, where more users are allowed to grow their own medical marijuana after authorization by a medical professional. The government runs a fairly informative website here.

You can chart the rise in the value of the public marijuana companies against the legal framework. Any time there was a court decision that broadened the rights of patients, or new regulations that allowed a wider class of patients to access marijuana, an uptick in the marijuana index followed as surely as smoke follows fire. That's why the index is up so dramatically since ACMPR was introduced in August. CEO's, CFO's and public relations firms are extolling the massive market waiting now to be tapped "when decrim happens".

Investors might be in for a money-losing shock.

There is a massive legal impediment to Canada decriminalizing marijuana use. It's part of the reason why the United States has not federally decriminalized it, and likely won't for the foreseeable future. It's why 185 countries around the world likely won't make recreational marijuana use legal, and why marijuana will remain subject to the *Controlled Drugs and Substances Act*.

That reason is called The Single Convention. It is an international treaty, managed by the United Nations. Enacted in 1961, the Single Convention codified then-existing multilateral treaties on drug control and extended the control systems to include the cultivation of plants grown as the raw material of narcotic drugs. This includes coca and its derivatives, opiates, synthetic opiates and yes, cannabis in all its forms.

Canada was a key player in the process leading to the signing of the Convention. The head of the drafting committee, Mr. R. Curran, was a Canadian, and Canada was one of the original countries represented throughout the negotiating process and the subsequent 1971 amendment process.

It is undeniable that Canada ratified and is bound by the Single Convention. It is a Party to the Convention. Other countries expect Canada to honor its legal obligations, just as Canada is entitled to expect the other signatories to live up to their obligations.

Compliance with a Convention like this is not optional. This is a legal agreement between all UN members. Canada can't stagger through its international treaties, picking and choosing which it will honor and which it will breach. As with any treaty there are consequences to breaching the agreement, consequences with ramifications extending far beyond this Convention. It affects Canada's role on the global stage, impairs the world view of Canada as good global citizens, reduces our ability to negotiate trade agreements, and reduces our moral authority exercised when chastising other countries (see, for example, Canada's comments on Chinese human rights).

Four lawyers from Bennett Jones LLP recently produced an analysis of Canada's options to get out of its obligations under the Single Convention. None of the options is particularly palatable. The wishy-washy conclusion in the analysis is further evidence that Canada, like all 185 signatories to the Single Convention, is bound by it.

I can't see Canada just sticking its thumb in the United Nations' eye. There has to be a plan, but it's asking a lot for investors to believe in any government's ability to plan long-term while having one eye on the next election. Maybe the government's plan is to push decrim as far as possible, thereby earning points with the voting electorate, only to suffer pushback from those evil geniuses at the UN, which

would give the government further points with the electorate. If Trudeau promised something he can't deliver, this would give him a way out.

I've had the opportunity to tour many of Canada's legal marijuana growing facilities, and to meet with many management teams. To spare them the embarrassment, they won't be named, but three of the Chief Financial Officers for legal growers said *they had never heard of the Single Convention until I asked them about it!* That's astonishing. In such a heavily regulated industry, the only real value is in the licence, and here we have three Heads of Risk not knowing a vital regulatory impediment.

To make it worse, when I pushed those three teams for their plan in case decrim either doesn't happen at all or doesn't happen until the Trudeau government is elected to a second term, the only answer was a mumbled "oh don't worry, that won't happen".

That's the kind of answer that ought to give investors pause for thought, which brings us to Warren Buffet's famous quotation:

Be Fearful When Others Are Greedy and Greedy When Others Are Fearful.

The Canadian marijuana industry has had a huge run since August, with investors blind to the possibility that marijuana use may never be decriminalized.

Investors who ignore the massive risk inherent in the Single Convention are whistling past the marijuana graveyard.