

Taking Stock with Steele

Your Monthly Newsletter

The purpose of this newsletter is to share insights and expertise. Our goal is to ensure that our clients are well informed of changes affecting local business decisions and our investment recommendations. We believe Knowledge Pays and we want our knowledge to help pay for you.

CANADA'S LEGAL CANNABIS MARKET HOW IS IT FARING ONE YEAR IN?

In previous cannabis market comments, we tried to cut through the hype and provide a realistic view of the Canadian legal cannabis market. We stressed that in a fledgling market, it was important for cannabis companies to have plenty of cash on hand, distribution agreements in place and well-established strategic partners. This realism has begun to hit the cannabis stocks but there could be much more downside ahead.

Size of the Canadian Legal Cannabis Market

Pre-legalization, the federal government estimated the size of the Canadian cannabis market (legal and illegal) at ~\$6 billion in year one. This estimate assumed the legal cannabis market would attain between 65%-98% market share.¹ Due to higher legal cannabis prices and lower illegal cannabis prices than expected, the actual legal cannabis market appears to be much smaller than expected. The average price for a gram of illegal cannabis is ~\$6 compared to ~\$8 pre-legalization while the average price for a gram of legal cannabis is ~\$11 versus \$8 to \$9 expected.² While edibles become legal next month, we are wary of the ultimate size of the legal cannabis market given current market prices for cannabis. The federal government's research shows that the legal market is likely to be contained at 34% given current legal and illegal cannabis prices, indicating a legal cannabis market of only ~\$2 billion.³

Production Capacity in the Canadian Legal Cannabis Market

As we noted in the past, legal cannabis producers have far too much production capacity. A year ago, we were concerned that legal cannabis companies had more than double the necessary capacity based on a ~\$6 billion legal cannabis market. Now that the actual legal cannabis market appears much smaller, our concerns about excess capacity and rationalization of legal cannabis supply have grown.

Capital Allocation of Cannabis Companies

Given the previous two factors, capital allocation is very important. Two key cannabis companies – Canopy Growth and Cronos – received significant capital injections from key strategic partners Constellation Brands and Altria. Canopy appears to have squandered most of its cash on overvalued cannabis investments while Cronos has been much more conservative with its cash. This will be a key differentiator over time.

Fraud Hits the Canadian Cannabis Sector

Cantrust, once one of the largest cannabis companies, fell from grace when its management allegedly knew they were growing cannabis in unlicensed areas. Who would have thought mostly unproven executives might make poor decisions?

We believe cannabis stocks remain uninvestable due to valuation concerns around legal cannabis market size as well as other risk factors.

Current Rates & Data

Govt of Canada

90 day	1.62%
1 year	1.72%
2 year	1.60%
5 year	1.46%
10 year	1.44%
30 year	1.61%

U.S. Treasury

90 day	1.95%
1 year	1.83%
2 year	1.70%
5 year	1.63%
10 year	1.78%
30 year	2.24%

Canada Prime Rate

3.95%

U.S. Prime Rate

5.25%

Exchange Rates

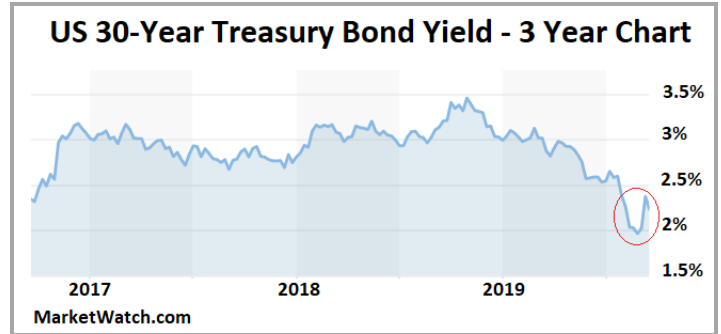
CAD/USD	0.754
USD/EUR	1.106
JPY/USD	108.2

ECONOMIC TIDBITS OIL PRICES SPIKE ON SAUDI ATTACK & BOND YIELDS RISE ON OKAY DATA

• An attack on the world’s largest refinery caused ~6% of global oil production to be temporarily shut-in. Oil prices jumped as much as 20% following the attack. The Iran-backed Houthi group claimed responsibility for the attack. Tensions are high as the Trump administration has previously stated it would hold Iran responsible for Houthi actions, raising the spectre of war in the Middle East.

Country	Million barrels per day	World Market Share
United States	17.87	18%
Saudi Arabia	12.42	12%
Russia	11.4	11%
Canada	5.27	5%
China	4.82	5%
Iraq	4.62	5%
Iran	4.47	4%
UAE	3.79	4%
Brazil	3.43	3%
Kuwait	2.87	3%
Total Top 10	70.96	70%

• Steadily worsening economic data, particularly in the global manufacturing sector, perpetuated a steady decline in global interest rates over the past nine months. In September, we saw a long overdue snapback in global interest rates driven by an apparent trough in global manufacturing activity combined with a growing service sector and resilient employment and consumer confidence data.



LE JIT A “JUST-IN-TIME” RUNDOWN OF OUR CURRENT INVESTMENT THEME

Illumina (ILMN): A Near Monopoly in One of the Most Novel Technologies of Our Time

- Illumina’s business currently focuses on reproductive health, population genomics, cancer research, rare disease research and consumer testing for sites like Ancestry.com and 23andMe. The cost to map a human genome fell from ~\$100 million in 2001 to just over \$1,000 in 2019. DNA sequencing has become much more commonplace in managing human reproductive risk and diagnosing various diseases. We are likely in the very early stages of learning how our DNA affects our health and Illumina is the leader.
- Illumina is the global leader in DNA sequencing and analysis with over 75% market share of sequencing machines deployed and generating over 90% of the world’s sequencing data.
- Illumina sells DNA sequencing machines as well as consumables and software necessary to generate genomic data. Given the complexity of genome sequencing machines and data output as well as the training required to decipher said output, ILMN appears to have a near-monopoly in its industry.
- Illumina trades at ~40x trailing EV/EBITDA, in line with other high growth health care stocks. Illumina shares recently fell ~30% from their all-time high primarily due to a slowdown in DNA testing related to consumer testing. While consumer testing provides Illumina with a high volume of DNA sequencing business, Illumina’s long-term opportunity lies more in scientific research and health care applications.

Key risk points: Illumina trades at a high valuation and therefore has high expectations for growth. Any disappointment in growth due to smaller-than-expected market size or competition would hurt the stock.

JEANNINE’S TIP O’ THE MONTH New Addition to the Steele Wealth Management Team!

Steele Wealth Management welcomes Sam Ryder, CFA to our team.

Sam brings a decade servicing hedge funds, private equity funds and alternative asset managers across Canada and the US. His alternative investment experience bolsters our team’s investment decision-making process.

Sam holds a bachelor of economics and finance from the University of Western Ontario and is a CFA Charterholder.

¹Wodrich, N. (2016). *Legalized Cannabis: Fiscal Considerations* [online]. Ottawa, Canada. Available at: <https://www.pbo-dpb.gc.ca>.

²Evans, P. (2019, July 10). *Illegal cannabis getting even cheaper, as legal gets costlier, StatsCan says*. Retrieved from <https://www.cbc.ca/news/business/cannabis-prices-1.5206554>

³Wodrich, N. (2016). *Legalized Cannabis: Fiscal Considerations* [online]. Ottawa, Canada. Available at: <https://www.pbo-dpb.gc.ca>.

This newsletter has been brought to you by Steele Wealth Management

Brian Steele, CA, CPA, CFA | Jeannine Campbell | Laura Prust, CIM, CPCA
Kelly Edmonds | Elizabeth Kernohan | Sam Ryder, CFA | Matthew Bell, CFA

Phone: (519) 883-6030 Toll-Free: 1 (877) 642-6408

Email: steelewealthmanagement@raymondjames.ca

Address: Unit 1, 595 Parkside Drive | Waterloo, Ontario | N2L 0C7

Website: www.steelewealthmanagement.com

To opt out of receiving this newsletter, please reply to this e-mail with the word “Unsubscribe” in the subject line.

If you know someone who would benefit from receiving this newsletter, please forward it to them and let them know they can subscribe by emailing us at: steelewealthmanagement@raymondjames.ca

Any bond, debenture or preferred share ratings listed within this newsletter are those of DBRS (Dominion Bond Rating Service).

All rates mentioned within this newsletter are as of September 19, 2019, unless otherwise stated. Rates have been sourced from Bloomberg. All stock information has been sourced from Market-Q.

This newsletter has been prepared by Steele Wealth Management and expresses the opinions of the author and not necessarily those of Raymond James Ltd. (RJL). Statistics, factual data and other information are from sources RJL believes to be reliable but their accuracy cannot be guaranteed. This newsletter is furnished on the basis and understanding that RJL is to be under no liability whatsoever in respect thereof. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. RJL and its officers, directors, employees and their families may from time to time invest in the securities discussed in this newsletter. This newsletter is intended for distribution only in those jurisdictions where RJL is registered as a dealer in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. Securities-related products and services are offered through Raymond James Ltd. Member-Canadian Investor Protection Fund. Insurance products and services are offered through Raymond James Financial Planning Ltd., which is not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds and other securities are not insured nor guaranteed, their values change frequently and past performance may not be repeated.

As the investment products listed in this newsletter may not be appropriate for everyone, a recommendation would only be made following a personal review of an individual's portfolio and risk tolerance.