Four smokin’ marijuana stocks going higher

How to capitalize on the surging sector

The marijuana sector has the most growth potential of any sector in Canada. That’s according to Jason Zandberg of PI Financial, who has co-authored a 51-page report, with colleague Devin Schilling, on the burgeoning industry. They’ve focused on four stocks they believe have strong upside. PI Financial has initiated coverage of the marijuana producers with a “speculative buy.”

They include: Canopy Growth Corp. (CGC-V), formerly Tweed Marijuana, Aphria Inc. (APH-V), Mettrum Health Corp. (MT-V) and Organigram Holdings Inc. (OGI-V). Investors looking for growth and momentum — and who have some risk tolerance — have been piling into these four weed stocks, sending them higher by between 125 per cent and more than 600 per cent in the past several months.

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Jason Zandberg, PI Financial
Capital Ideas Research spoke with Mr. Zandberg, who believes it’s not too late to capitalize on marijuana stocks because the sector is relatively small compared to what it could look like in two to three years. Mr. Zandberg believes Canopy, Aphria, Mettrum and Organigram have first-mover advantage as they were among the first companies to be granted licensed producers (LPs) status by the federal government to grow and/or sell medical marijuana. That gives them a “significant competitive advantage,” he thinks, over companies seeking or just recently awarded licenses.

“There’s a steep learning curve to this business,” Mr. Zandberg says. “They’ve probably got 70 per cent of the process of large commercial production under control. All four of these names have got a huge head start on anyone that enters the market from here on in.”

Marijuana sector set for strong growth

Mr. Zandberg says growth drivers for his four favoured marijuana companies include: an estimated 10-fold surge by 2024 in the number of patients in Canada prescribed medical marijuana; an expected federal government legalization of marijuana for recreational use; and the possibility of pharmacies eventually selling medical marijuana, likely in the form of cannabis oil.

That said, the strong rally in shares of Canopy and its peers was interrupted last week when the Government of Canada outlined new regulations called Access to Cannabis for Medical Purposes Regulations (ACMPR), which replaces the Marijuana for Medical Purposes (MMPR) program. ACMPR allows for patients to have the choice to grow their own plants or designate someone to grow on their behalf.

“We view the ACMPR as slightly negative for licensed producers,” PI Financial said in reaction to the changes. “The designated grower system has been abused as multiple designated growing licenses were combined at the same address – effectively creating a medium scale operation which supplied illegal dispensaries.”

PI Financial views the government’s measures as temporary and believes regulations will change again once government approves recreational use of marijuana.

“Although we believe that the designated grower system may continue to be abused and divert additional medical marijuana to illegal dispensaries, we continue to believe that the market is growing fast enough to absorb potential new supply and this new regulation is likely to be re-addressed in the short term,” it concludes.

In the spring of 2017, the government is expected to introduce legislation to legalize recreational marijuana with sales expected to start sometime in mid-2018, according to Mr. Zandberg.

He says Canopy, Aphria, Mettrum and Organigram still have the ability to roughly double their revenue every year through to 2019. He believes investors should build positions in the companies, as each have “several near-term catalysts.”

Mr. Zandberg’s thesis of what the key factors will be to determine success in the medical and recreational market are:

- Brand
- Capacity
- Cost Structure
- Product Quality

“That’s a necessary step to really have a mass market. When you have a Shoppers or a Rexall selling the medicinal cannabis oil, you get that additional level of legitimacy, and also increased access to patients. I think that will increase the awareness and thus increase the demand if we see the pharmacies getting involved in this market.”
Near-term catalysts

Let’s start with the growth potential of the sector. Since the federal government, under former Prime Minister Stephen Harper, ushered in the MMPR system in 2013, the number of patients prescribed marijuana, known as patient count, has grown to 53,649, according to Health Canada. The patient count surged 190 per cent year-over-year in March 2016. Monthly sales of marijuana increased in the 12 months ending in March by more than 200 per cent to 1,153 kilograms.

Health Canada expects the marijuana patient count to reach 400,000 by 2024 — a compound annual growth rate of more than 30 per cent. Mr. Zandberg believes that figure could hit 650,000 based on patient counts in the U.S., where 24 states have legalized the production and distribution of medical and, in some states like Colorado, recreational marijuana.

PI Financial foresees the total marijuana market in Canada to be worth about $4.6 billion the first year recreational use is permitted, followed by 10 per cent annual growth, eventually reaching $7.4 billion by 2022. By comparison, in 2013, Canadians spent $9.1 billion on beer and $21.4 billion overall on alcohol. Mr. Zandberg assumes the recreational market will make up about two thirds of the overall market after five years.

“To get triple digit growth on an organic basis is pretty unheard of,” Mr. Zandberg says. “Regulations have changed as to who can actually produce it legally and that’s created a huge amount of demand from specifically these four licensed products.”

The pharmacy factor

Canopy and its competitors could benefit if the federal government decides to open up the distribution network for medical marijuana beyond the current direct mail order system, according to the PI Financial report. “We believe the pharmacy environment is properly set up to handle the product (vaults on site) and has a gatekeeper (the pharmacists).”
“That’s a necessary step to really have a mass market,” Mr. Zandberg says. “When you have a Shoppers or a Rexall selling the medicinal cannabis oil, you get that additional level of legitimacy, and also increased access to patients. I think that will increase the awareness and thus increase the demand if we see the pharmacies getting involved in this market.”

The case for Canopy

Canopy Growth is the largest of the four marijuana companies Mr. Zandberg likes with a market value of about $250 million, roughly as large as Aphria, Mettrum and Organigram combined. Its facilities are in Smith Falls, Scarborough and Niagara-on-the-Lake, all in Ontario.

In 2014, Canopy became the first licensed seller in Canada of medical marijuana. The company grew its annual revenue 113 per cent in its quarter ending March 31. Canopy has partnered with rapper and affable pothead Snoop Dogg and with DNA Genetics, which regularly wins awards at the annual Cannabis Cup for its different strains of marijuana. Mr. Zandberg believes the company has been wise in teaming with these brands.

“Snoop Dogg definitely has a very strong brand, very well-known, so I think marketing of his image will be good in the recreational market,” Mr. Zandberg says. “And DNA Genetics is the best in the business at developing strong strains of marijuana, and by partnering with them Canopy is able to get up that very steep learning curve very quickly. They’ve been very smart with who they’re partnering with.”

Canopy’s strategy is different from some of its competitors in that it’s willing to be a higher cost producer in the short-term in order to develop new strains of marijuana for the anticipated recreational market.

“Canopy understands the market that exists today is small compared to where it’s going to be two or three years from now,” Mr. Zandberg says. “They’re focused on developing some awareness and some brand and not as concerned about getting their production costs to the absolute lowest that they can. I think it’s a smart move on their part to focus on making sure that when this recreational market comes, that they have the best product and some good brand awareness.”

The greenhouse effect

Aphria is at the other end of the spectrum from Canopy because it’s the lowest cost producer among Mr. Zandberg’s recommendations. The company grows its marijuana inside a greenhouse in Leamington, Ont. which “significantly reduces its power consumption.” Aphria grew its annual revenue 456 per cent in its quarter ending May 31 and was the first medical marijuana producer to have positive EBITDA (earnings before interest, taxes, depreciation and amortization). It’s worth noting Aphria’s management holds 31 per cent of the company’s outstanding shares.

“I wouldn’t suggest they’ve got an extremely strong brand but there will be that market niche for a very low-cost producer. They’ve sold their product to other LP’s that can’t keep up with demand, so there is a segment of the market where the lowest cost producer will add value. We think they’ll be successful at maintaining that cost advantage.”

Organic growth

Organigram is the only organic producer among Mr. Zandberg’s marijuana picks. One of the advantages of growing organic weed is that the plants
are smaller than non-organic plants because high potency fertilizers are not used. That means Organigram can squeeze more plants per square foot into its facilities in Moncton, New Brunswick. Management and employees hold 15 per cent of the company’s outstanding shares.

Mr. Zandberg explains Organigram’s growing process: “The problem with an organic plant is that you don’t get these massive plants with these huge buds on the top so they said why don’t three shelves of plants in each grow room so that on a per squarefoot basis we can still grow a lot of marijuana bud. It’s a unique approach. They also use LED lights, they’re the only ones that are doing that right now which lowers their costs.” Mr. Zandberg also believes Organigram will benefit from being based in the Maritimes.

“They’ll benefit from high market share in the Maritimes. Maritimers tend to buy from other Maritimers. They’ll follow similar to Moosehead Breweries where they’ve got a very high concentration, high market share in that Eastern Canada arena. Organigram will do that as well. They understand where their niche is and they’re well-focused on that.”

**Mettrum Health’s deep bench**

Mettrum Health Corp. has licensed facilities in Bowmanville and Creemore, Ont.. The company saw annual revenue jump 220 per cent in its quarter ended May 31. It also currently the strongest of Mr. Zandberg’s big four at growing its patient list which surged 300 per cent year-over-year as of June, 2016.

Mettrum’s management team is made up executives who previously worked at such notable companies as Red Bull Canada, Johnson & Johnson and Algonquin Power Income Fund. Mettrum founder and CEO Michael Haines previously built Hip Interactive into a $500 million company. Management holds 20 per cent of the company’s outstanding shares.

“**This has never been done before. Even in the U.S. it’s all very small grow operations as dispensaries basically supply themselves. We’ve never seen this mass commercial market. It’s a learning curve for everyone involved. It’s more complicated than I appreciated at the beginning of this journey.**”
What the smart money is doing

California-based Research Affiliates has created dozens of “smart beta” indexes for companies such as Pimco, Invesco PowerShares, and Charles Schwab & Co.

As of March 31, about $160 billion in assets were being managed worldwide using strategies developed by Research Affiliates, according to Barrons.

Chris Brightman, chief investment officer at Research Affiliates, has helped it become one of the most sought after investment concepts.

“Unlike traditional market-weighted indexes, smart-beta indexes employ alternative index constructive measures to create funds that overweight factors such as low-volatility, low valuation, and ‘quality’ earnings and cash flow,” Barrons notes in a recent interview with Mr. Brightman.

Mr. Brightman discussed both the concerns and opportunities for smart-beta investing — and a few personal investment tips. Below is an excerpt from that interview published recently:

Barrons.com: When your firm’s founder and chairman, Rob Arnott, published a report several months ago warning of a “smart-beta crash,” was he being overly alarmist or do you folks really believe that a crash is imminent?

Brightman: Well, over the last five years, there are a couple of categories of smart beta that have been performing very well as you noticed and attracting quite large inflows of assets. That’s because during the last financial crisis, stock prices of more profitable and higher quality and lower volatility companies had much lower declines or drawdowns than lower quality, higher volatility stocks. So that gave them a performance advantage certainly during that period, and then we had a other problems such as the drama in Greece and a slowing of the Chinese economy that made low volatility and quality indexes more attractive.

Q: Are dividends in a low yield world also part of the attraction of these stocks?

A: Yes. The stock market investors have been clamouring for some substitute for the bonds in their portfolio that no longer provide the yields that they need. Investors are saying, “Hey, I can have lower risk, higher quality companies that provide more cash flow and they are going to outperform the rest of the market.” All this sounds too good to be true to us. This is the point of Rob’s paper in February. All of the outperformance over the last decade is a function of rising relative valuation. Their price-earnings multiples and price-to-book multiples have been going up relative to their typical relationship to the overall market; it’s that rising relative valuation that explains all of the performance that doesn’t seem to be a sustainable source of excess returns.

Q: So when will these funds crash or fall hard? What kind of catalyst do you expect to start the crash?

A: Everyone asks that question. But can you tell me what the catalyst was in March 2000 that caused the tech bubble to burst? I certainly can’t. Sometimes I chuckle and say its gravity. When things get very expensive, they crash.

Q: So is this a bad time to be in a low volatility fund?

A: If you have made an allocation to low volatility because you want to have the benefit of an equity portfolio with lower volatility, and you are committed to that for the long run, and you don’t expect higher returns -- you merely expect lower volatility -- I see no reason to panic and dump your low volatility portfolio. However, if you are thinking of jumping into low volatility now, because you think it is a way to outperform the market, I would advise you to reconsider that deal.

To read the full interview click here (Barron’s subscription required)
First look — This week’s initiations:

Canaccord Genuity initiated coverage of PRO Real Estate Investment Trust (PRV.UN-V) with a “buy” and $2.40 target. The stock is currently trading around $2.15.

“PROREIT is a relatively new and growing diversified commercial REIT with a focus on Atlantic Canada and Quebec,” analyst Jenny Ma said in a note. “The REIT is highly acquisitive and has quickly grown its portfolio over the past three years to 33 properties totalling 1.7 million square feet.”

She said the REIT is led by a “capable and experienced management team that has demonstrated a track record of delivering unit-holder returns.”

The REIT also has a “unique market position as the dominant landlord in secondary and tertiary Atlantic Canadian markets,” and owns “high-quality assets in good locations and occupies a sweet spot in the smaller secondary and tertiary markets by being neither too big nor too small.”

Ms. Ma also said the REIT has a strong cash flow growth profile and attractive valuation.

“On balance, we believe PROREIT offers investors an opportunity to invest at the ground level with a proven and aligned management team.”

Acumen Capital analyst Brian Pow initiated coverage of Cargojet Inc. (CJT-T) with a “buy” rating and $38.50 price target for the stock. Consensus is $36. The shares are currently trading about $34.50. The analyst consensus price target over the next year is $36.

Mr. Pow said the stock is "ready for lift-off" with its dominant position in Canada's air cargo industry. He cited a demonstrated ability to operate a co-load network, and long term contracts that ensure revenue certainty until at least 2020.

“We estimate that the core network contributed approximately $250-million or 80 per cent of Cargojet’s revenue over the trailing twelve months ended March 31, 2016 (including fuel and other cost pass through),” he said in a note. “Without a catalyst, we expect revenues from the core network to increase at a rate in line with GDP growth.”

Among four analysts that cover the stock, three have a “buy” and one has a “hold.”

BMO Nesbitt Burns initiated coverage of AdvancePierre Foods Holdings Inc. (APFH-T), with an “outperform” and $29 (U.S.) target. The shares are currently trading around $24.85 on the NYSE. Consensus is $28.

Analyst Kenneth Zaslows called it “a conservative investment vehicle that should outperform its peers, as its new - albeit experienced - management team continues to re-shape the company to deliver above-average top-line growth and steady margin expansion through internal actions.”

He cited a few reasons why he thinks the stock should drive shareholder, including: “1) capturing secular and whitespace growth opportunities; 2) leveraging its market share position in niche categories to maintain its dynamic pricing model; 3) reinvesting prudently in growth and productivity initiatives; 4) de-levering its balance sheet; 5) delivering a top-tier food dividend yield; and 6) seeking and integrating bolt-on acquisitions.”

The stock has three “buy” and one “hold” recommendation among the four analysts that cover it.
Shares of CanWel Building Materials Group Ltd. (CWX-T) are undervalued, according to Raymond James analyst Steve Hansen, who raised his target price on the stock to $7.25 from $6.50. Consensus is $6.95. The stock is trading around $6.75.

“Consistent with last quarter, gross margin continues to surprise on the upside,” Mr. Hansen said in a note commenting on the company’s latest earnings. “Specifically, 2Q16 gross margin improved 180 bps [basis points] year over year to 13.7 per cent benefiting from the higher value-added operations of recent tuck-ins, emerging revenue/cost synergies (i.e. chemicals), and incremental market share gains associated with the firm’s domestic lumber treatment strategy.”

Mr. Hansen raised his 2016 and 2017 earnings per share forecasts to 52 cents and 62 cents, respectively, from 45 cents and 55 cents. Mr. Hansen maintained his “outperform” rating on the stock. All six analysts that cover CanWel have a “buy” rating on it.

BMO Nesbitt Burns raised its target price for Franco Nevada Corp. (FNV-T, FNV-N) to $108 from $95 after its second-quarter earnings beat expectations. Consensus is $95.61. The stock is trading around $102 on the TSX.

Adjusted earnings per share came in at 22 cents, beating consensus of 20 cents and BMO analyst Andrew Kaip’s projection of 17 cents.

“The earnings beat relative to our expectations was attributed to higher revenue, mostly from Antamina, Antapaccay, and Sudbury,” Mr. Kaip said. “Operating cash flow was lower than expected as a result of a $27.9-million draw on working capital, including $38-million in prepaid expenses. Investing cash flow for acquisitions was slightly ahead of our estimates by $10-million.”

Mr. Kaip maintained his “market perform” rating for the stock. Among 16 analysts that cover the company, eight have a “buy,” seven have a “hold,” and there’s one “sell.”

Desjardins Securities analyst Maher Yaghi upgraded a number of telecom stocks, citing “generous income, unlike a lot of commoditized fixed-income products.” However, he said there are risks “in the event [interest] rates rise significantly or increased competition creates a pricing shock.”

Mr. Yaghi made the following changes to his target prices:

**BCE Inc. (BCE-T, hold)** to $68 from $64. Consensus is $60.97.

**Quebecor Inc. (QBR.B-T, buy)** to $45 from $44. Consensus is $43.64.

**Rogers Communications Inc. (RCI.B-T, hold)** to $61 from $56. Consensus is $54.67.

**Shaw Communications Inc. (SJR.B-T, buy)** to $30 from $28. Consensus is $26.40.

**Telus (T-T, buy)** to $50 from $46. Consensus is $43.90.
Notable Insider Buying and Selling

Shaw Communications Inc. (SJR.B-T) executive chairman JR Shaw has recently been buying again, spending $5.27-million picking up shares in the public market, INK Research CEO Ted Dixon wrote in the Globe and Mail recently.

From July 25 to 29, Mr. Dixon said Mr. Shaw acquired a total of 200,000 Class “B” Non-Voting Shares at an average price of $26.37. “Mr. Shaw is the largest insider equity holder at the company, holding about 4.1 per cent of shares outstanding,” he wrote.

Shaw reported fiscal third-quarter revenue of $1.28-billion, up from $1.14-billion a year earlier, thanks in part to $132-million from its wireless division.

Seymour Schulich sold 10 million common shares of Birchcliff Energy Ltd. (BIR-T), according to a release on Aug. 8. He now owns 35 million shares of the energy company.

“Royal Bank of Canada is the underwriter of the sale and Mr. Schulich has committed to no additional sales for at least the next 45 days,” the statement said.

It also said Mr. Schulich’s philanthropic endeavors are “consuming more time, attention and resources.”

“This estate planning transaction is part of a plan to substantially increase the growing pool of funds available to invest in Canada’s future via constructive philanthropy, primarily in the area of educating the country’s brightest students.”

Birchcliff shares has risen more than 115 per cent so far this year.
Other analyst actions:

Agnico Eagles Mines Ltd. (AEM-N, AEM-T) was downgraded to “sector perform” from “outperform” by RBC Dominion Securities analyst Stephen Walker. He raised his price target for the stock to $67 (U.S.) from $65. Consensus is $55.86.

Artis Real Estate Investment Trust (AX.UN-T) was downgraded to “sector performer” from “sector outperformer” by CIBC World Markets Alex Avery. He lowered his price target to $14 per unit from $14.50. Consensus is $14.47.

B&G Foods Inc. (BGS-N) was downgraded to “neutral” from “buy” by Davidson analyst Eric Gottlieb. He maintained a $52 (U.S.) price target. Consensus is $50.43.

CAE Inc. (CAE-T) was downgraded to “neutral” from “outperform” at Macquarie Research by analyst Konark Gupta. His target remains $18. Consensus is $18.60.

Canadian Apartment Properties Real Estate Investment Trust (CAR.UN-T) was downgraded to “market perform” from “outperform” at BMO Nesbitt Burns. Analyst Heather Kirk maintained her target price of $32.50 per unit. Consensus is $32.93.

Canadian Energy Services and Technology Corp. (CEU-T) was upgraded to “hold” from “sell” by Industrial Alliance Securities analyst Elias Farcolos. He raised his target to $3.75 for the stock from $2.90. Consensus is $4.98.

Dish Network Corp. (DISH-Q) was upgraded to “outperform” from “neutral” over at Macquarie. Analyst Amy Yong maintained her target price of $62 (U.S.). Consensus is $70.95.

Gap Inc. (GPS-N) was raised to “neutral” from “underperform” by Mizuho Securities USA analyst Betty Chen. She raised her 12-month target price to $24 (U.S.) per share from $17. The average is $22.01.

Linamar Corp. (LNR-T) was raised to “buy” from “speculative buy” by Cormark Securities analyst David Tyerman. His target went to $59 from $58. Consensus is $64.67.

Norbord Inc. (OSB-N, OSB-T) was downgraded to “market perform” from “outperform” by BMO Nesbitt Burns analyst Mark Wilde. He maintained target of $26 (U.S.). Consensus is $28.32.

Perpetual Energy Inc. (PMT-T) was downgraded to “reduce” from “hold” at TD Securities. Analyst Aaron Bilko He lowered his target to $2 from $2.50. Consensus is $2.35.

Peyto Exploration & Development Corp. (PEY-T) was downgraded to “neutral” from “outperform” at Macquarie Research by analyst Brian Bagnell. His target rose to $36 from $32. Consensus is $39.86.

Premium Brand Holdings Corp. (PBH-T) is a “hold” at Canaccord Genuity, but analyst Derek Dley increased his target to $57 from $54. Consensus is $65.71.

Richmont Mines Inc. (RIC-T) was downgraded to “sector perform” from “sector outperformer” over CIBC World Markets. Analyst Jeff Killeen also raised his price target to $14.50 from $14. Consensus is $15.02.

Superior Plus Corp. (SPB-T) was upgraded to “outperform” from “market perform” at Raymond James. Analyst Steve Hansen raised his target price for the stock to $12.50 from $12. Consensus is $12.44.

Vermilion Energy Inc. (VET-T, VET-N) saw its target price increased by Desjardins Securities analyst Kristopher to $52, up from $47.50. Consensus is $50.52. He has a “buy” on the stock.

Weyerhaeuser Co. (WY-N) was downgraded to "neutral" from "buy" at Davidson. The firm maintained a $33 (U.S.) target for the stock. Consensus is $35.22.