

Executive summary

According to Stats Canada report, almost 5 million Canadians consumed Cannabis products last year and spent almost \$5.7 billion dollars on the way. From these numbers, it is safe to assume that Canadians demand for Cannabis is there. With legalization set for October 17, it is going to be a big month for weed smokers, producers and tax collectors, but whether it will be as exciting for investor's remains to be seen.

What you need to know

Cannabis stocks have been on fire over the last few years. The Marijuana Index, an index that tracks cannabis company shares, is up about 573% since 2015. Early investors have seen ample return on their dollars over the last number of years, but that doesn't necessarily mean that new investors will see similar results. Until now, the entire sectors value has been based purely on expectation and speculation. Weed stocks do not seem to be trading at reasonable valuations and investors need to be prepared for the possibility that the growth they are hoping for may not materialize. In fact, it may take years for these companies to see any meaningful results.

While Canadians may see stock prices continue to rise in the months after legalization, it is reasonable to expect that any immediate growth will be driven by hype. History shows us that when the hype dies down and companies still haven't turned a profit, there is bound to be a market correction; and a big one. Investors saw something similar in the 1990 dot-com bubble and with last year's crypto currency mania. The product consumers are investing in have to perform for investors to see positive returns. However, whether the weed industry is going to be huge is not even a question. Statistics show us that the demand for recreational marijuana is there. The big unknowns are how the government is going to handle different aspects of the industry and how the production companies are going to make themselves competitive.

Perhaps the most challenging hurdle for the government and cannabis producers is competition with the black market. Remember the Stats Canada report? Of the 5 million Canadians who consumed marijuana last year, 90% of them did so illegally. According to research released by the CD Howe Institute, a leading think tank on Canadian policy, it is expected that illegal suppliers will still control almost half the market after legalization. This tells us is that consumers are not above turning to less-than-credible sources for their weed. How quickly people go from their dealer to a dispensary may have a significant impact on the early profits of legal cannabis producers and the transition may not be as quick as the government may like to think. The legal market will have to be competitive with the black market with regards to product pricing and accessibility. Due to the strict advertising and packaging regulations that the government put in place earlier this year, there may be little incentive for consumers to switch from their dealer to the legal market if they can't keep their prices low.

Another major challenge that the industry might face is the classic supply vs demand dilemma. Marijuana is an agriculture product that needs time to be planted, grown, and harvested. Producers are going to have to think about shortages, and then about surpluses. While many producers are likely ready for the initial boom of recreational buyers, there could be cause for trouble in the long term if demand is as high as expected. Producers will need to be able to keep up with the supply for their product if they want to continue to make a profit, otherwise there will be even more incentive for consumers to turn to the black market where there is seemingly never-ending availability of product. Conversely, a shortage of weed may cause a competitive production frenzy which could end in a production surplus, and the producers will lose all the same. It will be important for investors to pay attention to how this cycle pans out of the next year or so, as it may be a key indicator of how the industry will fare.

The bottom line

What this all means for investor's remains to be seen. What financial experts do know is that cannabis stocks have big shoes to fill with their current prices, and the research is there to suggest that the transition to legal recreational weed may not be as smooth as expected. This may not be a concern for seasoned investors with deep pockets, but for new investors who are looking to make a quick profit off the hype, this could be bad news. As with any new industry, only time will tell and it's looking like the success of cannabis producers is going to be a long-term game. As always, investors should do their research and work with a financial professional before becoming involved in any speculative industry.

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