

# Cannabis in Canada Industry Report

## Exploring a Blooming Industry

### Introduction

As of October 17<sup>th</sup>, 2018, Canada has become the first G-7 country to federally legalize adult-use cannabis. The market now sits in the midst of a consistent change as shift with evolving customer needs, regulation, and company dynamics. Nevertheless, it has already enticed investors to pour billions of dollars into cannabis companies.

### Overview of the Canadian Cannabis Landscape

The new but fast-growing industry is based on regulation but also a lot of potential. As a result, exploring the regulation, consumer behaviours drivers, adjacent industry structure, and overall market characteristics leads to key implications and considerations for investment.

### Exploring Industry Players

From comparing and contrasting the four largest companies in the Canadian cannabis market, Canopy Growth, Tilray, Aurora, and Aphria, we can draw some high-level takeaways regarding company strategies, future growth trajectories, and competitive advantages.

### The Future of Cannabis in Canada

As regulation loosens, rising customer expectations are driving consumer trends and brand development, while investor pressure is influencing producer behaviour. Consolidation, global expansion, and the introduction of adjacent industries are general trends that are expected to continue.

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## Overview of the Canadian Cannabis Landscape

### The Cannabis Act

As of October 2018, the Canadian Federal Government legalized, subject to some stipulations, recreational and medical cannabis use. This act allows individuals to: “possess up to 30 grams of legal cannabis, dried or equivalent in non-dried form in public, share up to 30 grams of legal cannabis with other adults, buy dried or fresh cannabis and cannabis oil from a provincially-licensed retailer, in provinces and territories without a regulated retail framework, individuals are able to purchase cannabis online from federally-licensed producers, grow, from licensed seed or seedlings, up to 4 cannabis plants per residence for personal use, make cannabis products, such as food and drinks, at home as long as organic solvents are not used to create concentrated products.” Notable restrictions include: edible products not being available for legal sale until approximately a year after the official legalization date (October 17, 2018), sale not being legal to individuals below 18 years of age. Significantly, it is illegal to promote cannabis products, except in situations where youth cannot see the advertisement, produce products appealing to youth, package products in ways that are appealing to youth or sell the products through self-serve means (i.e. vending machines). The primary goals of the act are to “keep cannabis out of the hands of youth, keep profits out of the pockets of criminals [and] protect public health and safety by allowing adults access to legal cannabis”.

A factor sometimes overlooked is the degree of provincial power in the manifestations of this act within the provinces borders. Provinces have, for example, the power to raise the minimum age for legal cannabis use, change the limit of possession that an individual is legally allowed to possess, change the distributive outlets from which cannabis can be legally purchased and where it can be legally used, among other powers. Ontario, for example, has exercised many of its powers, raising the minimum age of consumption to 19 and limiting the areas in which cannabis can be consumed among other restrictions.

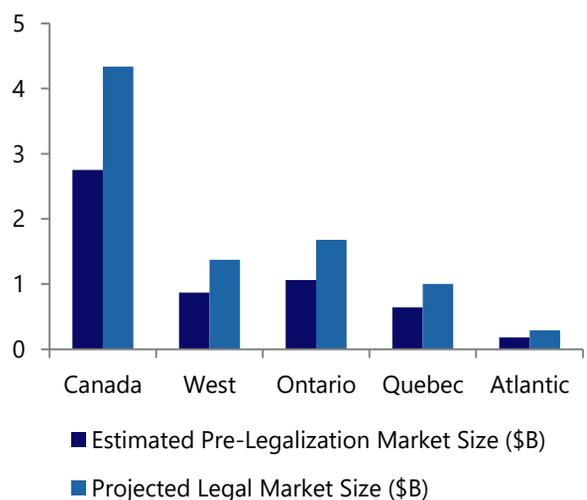
### Market Characteristics

Understanding the cannabis market at this stage in its legal development presents a distinct challenge. It is an analytical feat not needed to the same degree since the end of prohibition. As such, fully comprehending the nature of the cannabis market will likely be, for both retailers and analysts, an imperfect science for years to come. The findings in this report therefore must be understood to include a greater degree of uncertainty than is usual for our analyses.

With projected total sales of \$7.17B in 2019 and dramatic expected growth, it is clear why the profit potential of the Canadian cannabis industry has greatly intrigued investors. While only a little over half of these projected 2019 sales are expected to be serviced by legal channels, due to a price premium and supply shortage of legal product, the legal market is expected to eventually take larger market share from illicit channels, up to about 2/3 of the cannabis market.

#### EXHIBIT I

Recreational Cannabis: Market Size



Source(s): Deloitte

## Overview of the Canadian Cannabis Landscape (Continued)

Currently the vast majority of cannabis sales are in the form of concentrates. Concentrates are any product which you create by an extraction process and are commonly used in products like vaporizers and oils. The next most common product is dried cannabis, a form that is typically smoked, followed by seeds.

Legalization will likely normalize cannabis use in the mind of consumers. As a result, the legal cannabis market is projected to be much larger than the pre-legalization black market. In fact it is projected that the global market will be worth \$57B, globally, in 2027.

### Recreational Consumer Overview

#### Demographics

Who buys enough cannabis to support this growing industry? The response to the question may be very different post-legalization. While it is true that the average cannabis user pre-legalization was between 18-34 and at maximum a high school or college graduate, the average consumer profile post-

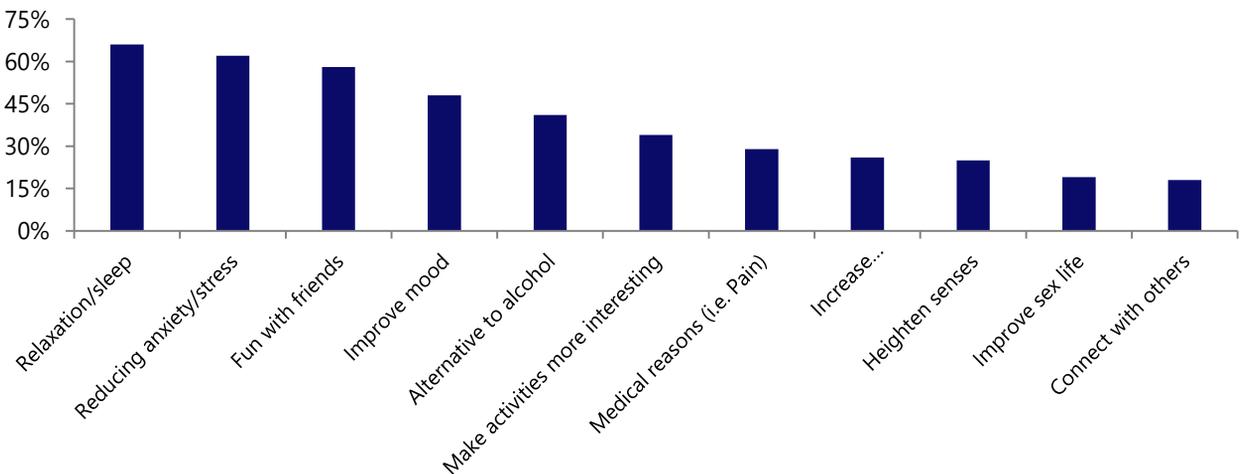
legalization is far different. They are older (35-54) and better educated (university or graduate school degree at maximum) ("the new consumer"). While the new consumer is predicted to be a much less frequent user of cannabis (a monthly user versus the current user who often consumes multiple times per week), they present an appealing opportunity for cannabis companies to expand the breadth of their offerings to attract this more sophisticated buyer. The appeal for retailers to attract the new consumer is significant, as the new consumer is projected to spend ≈68% more per cannabis purchase, than the current consumer.

#### Needs Fulfilled by Cannabis

Consumers are using cannabis to meet a very diverse set of needs, such as relaxation and connecting with others. It is difficult to predict how these consumption triggers will change with the growing prevalence of the new consumer. However, it seems likely that new drivers of consumption will appear, such as a desire to feel younger and nostalgia.

### EXHIBIT II

Common Current Uses of Recreational Cannabis



Source(s): Deloitte

## Overview of the Canadian Cannabis Landscape (Continued)

### Price Sensitivity

Price sensitivity is a key consideration in determining the profitability of the cannabis industry. In fact, 75% of users pre-legalization stated that they would look for products offered at reasonable prices. Research has shown that the more frequent the cannabis user, the more price sensitive. While this is not altogether surprising, it is an unfortunate truth which erodes the profitability of a segment which one may expect to be "cash cows". The new consumer who is brought to cannabis use due to its legalization are expected to be less price sensitive. Both groups however are expected to pay a premium for cannabis, up to an average of 9% of its current cost.

### Alternative Viewpoints

It is important to consider the arguments of dissidents when evaluating the size, growth and nature of the future cannabis market. A major point of contention between consensus and dissidents is the potential market size of cannabis. A key reason for the contrast in projected market size is disagreements over the

conversion rate of first-time cannabis user to life-time user. While not a perfect proxy for lifetime use, a 1994 study reported that 9% of individuals who had ever tried cannabis fit the characteristics of dependency. Alcohol, by contrast, was found to have a rate of about 15%. Alcohol is being used as the basis for much of the predictions of the cannabis market as it is the only true historical comparable. Is it possible that alcohol has become too salient in analysis of the cannabis market, given that the two drugs are not fully comparable? If so, predictions of the nature of the cannabis market could be inaccurate. Particularly, the predictions of the prevalence "new consumer" could be vastly exaggerated, as cannabis has a lower dependency rate. This means that the new consumer may not reach the level of use popularly estimated, limiting the market size of the cannabis industry. Instead, the companies would be left with the current heavy users who tend to be young, less educated consumers, 37% of whom would not purchase legal cannabis at a \$1 premium. This illustrates a far less

### EXHIBIT III

Average Price of Cannabis (\$US)



Source(s): Statistics Canada

## Overview of the Canadian Cannabis Landscape (Continued)

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attractive market. This example highlights a larger issue with evaluating the cannabis market at this early stage: consensus beliefs without a basis in concrete data are often challenged by equally believable dissenting opinions.

### Implications for the Future

#### Cannabis' Future

Overall we do believe that the cannabis market in Canada has the potential to be extremely profitable. While we understand that assumption-based predictions are extremely unlikely to be truly accurate, we feel confident that the legalization of the cannabis market will result in the introduction and overwhelming prevalence of the "new consumer". A primary reason for our confidence in this is that we believe that the legalization of cannabis will catalyze the development of a complex retail portfolio in which products will vary in their form, function and ultimately, target market. This will increase the appeal of cannabis for a wide variety of consumers. We imagine a cannabis market which will be smaller than the alcohol market (unlikely to challenge alcohol prevalence at mealtimes, less acceptable to smoke in public, difficult to create the culture of use that alcohol has (i.e. sports games) etc.).

#### Canadian Cannabis

One question that we have yet to cover is the potential for Canadian cannabis companies to become global juggernauts. Canada is on the forefront of the growing trend that is legalization. Uruguay was the first country to legalize cannabis, Canada is the first G7 country to do so and 10 US states have accepted recreational legalization. Canada's early acceptance of cannabis has the potential to give its domestic companies first-mover advantages. If Canadian cannabis companies are able to develop complex product portfolios, distribution networks and business models, when more countries become receptive to the idea of recreational cannabis legalization, Canadians may be able to gain

dominant market positions in these countries. Of course, this is regulation dependent and Canadians may find that countries implement purely state-owned cannabis retailers, limits to foreign ownership of cannabis retailers, among other potential regulations. Regardless, it is unlikely that Canadian firms will be blocked from all potential international markets, especially if they are able to develop superior brands and businesses. Of course, the capacity for corporations to develop strong business models depends on the degree of and nature of regulation that they face domestically. This is likely to be a large hurdle for cannabis players. Public stigma against cannabis use, the Federal Government's somewhat "hands-off" policy with regulatory guidelines and provincial regulatory control, is likely to create a patchwork of restrictions which differ across provincial lines and are unstable for years to come. This will make it difficult to create consistency in companies' strategies and business models. However, in the case of international expansion, it will provide Canadian companies with a plethora of strategies to deal with the regulations that they may face abroad. Already, Canadian companies are facing harsh provincial regulations. For example, in November, Ontario ruled that licensed producers of cannabis are unable to own more than 9.9% of a cannabis retail store. This regulation is designed to hinder corporations efforts towards vertical integration in the cannabis market. BC has introduced similar legislation and also mandated that that all stores receive cannabis supply from a government controlled distribution system that separates sellers and growers. This complex regulatory landscape is developing, with several provinces still in the midst of creating their specific regulatory landscape. The key question to consider moving forward is whether this landscape will be conducive to the creation of internationally competitive businesses or just sheltered domestic players. This will greatly impact the profit potential of the Canadian cannabis industry for years to come.

## Overview of the Canadian Cannabis Landscape (Continued)

### Adjacent Industry Competition

**Alcohol:** According to a recent report from CIBC, Marijuana will be a \$6.5 billion industry by 2020 in Canada, significantly more than the \$5.1 billion Canadians spent on liquor in 2017. While spirits and wine sales have been increasing nationally, slumping beer sales have hurt the overall alcohol sector. Many liquor boards across Canada are playing a prominent role as distributors and retailers of Cannabis and are expecting to discover that Cannabis sales are creeping into their profits, with beer expected to be the first industry to be hit. According to Bloomberg Intelligence, beer and cannabis both contain young males as a core customer, leading to the assumption that marijuana oriented items such as vape pens and edibles could detrimentally affect beer sales. With this in mind, it has also been noted that the best course of action for the alcohol industry to combat this is to become directly involved with Cannabis. Constellation Brands, the parent company of Corona, has already purchased a \$6.6B minority stake in Canopy Growth. Molson Coors have shown interest in investing in Aurora Cannabis and entered into a joint venture with HEXO, a Quebec marijuana cultivator this past August. Continuing this trend, the cannabis industry is supporting the development of cannabis-infused craft beer. Lagunitas, Heineken's fast-growing beer company, which was acquired in 2017, has introduced a new drink known as "Hi-Fi Hops" which contains zero alcohol, and is made with THC, the main chemical in Marijuana. Based off of these investments

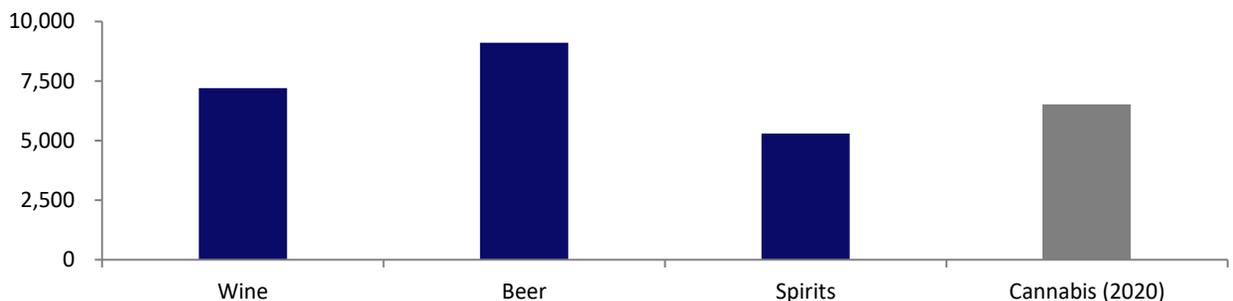
as well as industry research and data, it is likely that cannabis-based craft beers will continue to grow in popularity, and they are projected to account for as much of 30% of the total cannabis market in the near future.

**Medicine:** Researchers across Canada and the US are studying cannabinoids, chemicals found within Cannabis such as THC, which have drawn specific attention in terms of their impact on epilepsy, cancer, anxiety, and neuropsychiatric disorders. Alongside this a recent study on medical marijuana in the US, reported that 80% of users felt that the drug helped to reduce chronic pain. With over 100 cannabinoids and counting having been found, opioid prescriptions are falling; continuing the 4.9% decrease in opioids dispensed in Canada between 2012 and 2016.

**Pharmaceuticals:** With the increase in medical marijuana prescriptions worldwide, the pharmaceutical industry is expected to lose \$4B per year according to the University of Georgia. This has been in full effect in Canada, specifically through the increasing application of Cannabis in the treatment of anxiety, sleep disorders, and pain. Further, Canadian Cannabis Producer Tilray just announced a partnership with Norvaris Pharmaceuticals, the first of its kind.

### EXHIBIT IV

2017 Alcohol Sales in Canada (\$M) compared to Cannabis Projected Sales



Source(s): Bloomberg Intelligence, Government of Canada, OCS, Forbes

## Overview of the Canadian Cannabis Landscape (Continued)

### Distribution of Cannabis

Cannabis distribution begins with federally licensed producers. It is then transported to a government warehouse, where it is distributed to the public and private stores, as well as sold online through government websites. Certain provinces such as Ontario currently do not have any physical locations, however other provinces such as British Columbia will offer retail sales through regulated public stores and private stores with government support.

Roughly one-half of cannabis users plan to purchase cannabis from public and private stores. Additionally, one-third of cannabis customers carry interest in purchasing cannabis online from government and private retailers. This can be attributed to the stigma surrounding cannabis usage, enabling customers to keep their privacy with regards to consumption.

Due to legal distribution, cannabis consumers are also expected to pay more for quality government-

regulated cannabis, and hold high expectations as a result of inflated prices. Expectations of consumers regarding the distribution of cannabis include well-informed staff and clear prices. When viewing a pharmacy, the pharmacist must be knowledgeable about their product. Cannabis stores are also prioritizing cyber and physical security for maximum customer privacy, along with an engaging and pleasant customer service. According to recent surveys, this encompasses 61% of all expected customers. Alongside this all consumers exhibited an expectation that all cannabis will be distributed in a safe area away from children.

The success in the distribution of cannabis relies on knowledgeable staff and clear prices. These aspects are extremely interchangeable among multiple retail industries, and their success will stand as interesting metrics to evaluate companies sales strategies with regard to consumers in the future.

### EXHIBIT V

Cannabis Distribution Cycle in Canada



## Exploring Cannabis Industry Players

The four largest players in the Canadian cannabis market by market capitalization are Canopy Growth, Tilray, Aurora, and Aphria.

These businesses hold licenses from Health Canada as part of the Cannabis Act for each of their greenhouse facilities. Within these facilities, these companies grow their Cannabis plants, produce the final product, and lastly package the product before shipping it to the customer. These businesses are also able to sell cannabis in wholesale to other Licensed Producers (LP's). The Cannabis Act charges an excise tax on adult-use sales.

Due to the recent legalization of adult-use cannabis in Canada, demand and supply has increased significantly and will continue to increase. As a result, analyzing historical performance is not very insightful. For example, Aurora's average production cost per gram was \$1.90 for the quarter ended September 30, 2018. However, with heightened scale and growing efficiencies the company expects to lower its cannabis

production cost to less than \$1 per gram. For some perspective on scale, Aurora sold just 2,676 kilograms of cannabis in that same quarter (10,704 kilograms annualized), but is expected to have production capacity of roughly 500,000 kilograms by mid-2020. We use Aurora as an example, but given the limits of the medicinal markets these companies used to operate in, their financial profiles are similar.

To increase margins, these companies are also pushing products that are more sophisticated than just dried buds. Beverages, vape cartridges, softgels/tablets, and CBD infusions are all higher-margin products. Moreover, they are pushing more premium products to the adult-use market, including premium dried bud. As in other consumer industries, a well sought-after brand can vastly improve margins.

### EXHIBIT VI

The Four Largest Canadian Cannabis Companies By Market Capitalization



\$19.8B



\$9.5B



**AURORA**<sup>®</sup>

\$8.5B



**aphria**<sup>™</sup>

\$2.2B

Source(s): Capital IQ

## Exploring Cannabis Industry Players (Continued)

To justify their lofty valuations, these companies will have to continue growing rapidly while also becoming profitable. For example, in the quarter ended September 30, 2018, Aurora's revenue was just shy of \$30M but is valued at \$8.5B.

Although these four companies currently have very similar businesses, their strategies for the future are different. In a race to build their brands, create new products, and attract more customers, these companies have chose to partner with some brand behemoths in various degrees. Moreover, these companies have expanded their reach internationally. One of the most lucrative markets is Germany, which has a federally legalized medical cannabis market. This is a large market given that Germany has a population of 82M, however the most lucrative aspect is that Germany currently has an import-only policy.

### Key Takeaways

From studying these companies, we can draw some high-level takeaways. Most companies claim that their goal is to become the most trusted brand, earn the highest market share, and that they have a production competitive advantage which results in the lowest cost. These ambitions do not sound like a recipe for financial success. It is also not likely that a cost advantage will be the key to success. One company that seems to have focused on a certain market segment is Canopy Growth and its beverage partnership with Constellation Brands. Tilray's medical cannabis partnership with Novartis is a similar strategy. Overall, cannabis companies need to establish their brands in certain market segments. It is not rational to try to compete in every market, especially when the main ingredient is a commodity.

### EXHIBIT VII

#### Various Industries Entering the Cannabis Space

PHARMACEUTICALS	ALCOHOL	FUNCTIONAL FOOD & BEVERAGES	TOBACCO
 <small>DEAL ANNOUNCED: MARCH 19, 2018</small>	 <small>DEAL ANNOUNCED: OCTOBER 30, 2017</small>		 <small>DEAL ANNOUNCED: FEBRUARY 8, 2018</small>
			 <small>DEAL ANNOUNCED: JUNE 28, 2018</small>
			
	 <small>DEAL ANNOUNCED: AUGUST 1, 2018</small>		
 <small>TEVA PHARMACEUTICAL INDUSTRIES LTD.</small>			

Source(s): Tilray Investor Presentation

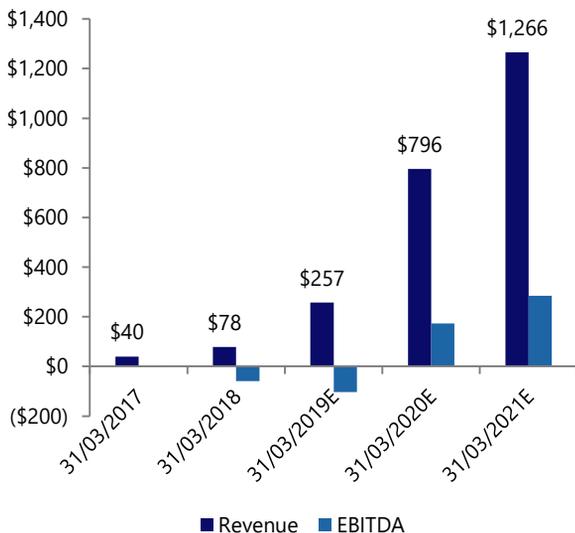
## Exploring Cannabis Industry Players – Canopy Growth Corp.

Canopy is the largest Canadian cannabis company by market capitalization. The company is licensed to produce cannabis at 10 facilities located in Canada, but has operations in 12 countries.

Canopy is considered to have pioneered the cannabis industry in Canada. The company believes it has 36% share of supply agreements signed to date, and 30% share of all available SKU's in Canada.

### EXHIBIT VIII

Canopy Growth Revenue and EBITDA (000's)



Source(s): Capital IQ

### Products

Canopy offers an array of different cannabis products, including dried flower, oils, and softgels.

Spectrum Cannabis is the company's medical cannabis brand. In the adult

In the adult-use market, Canopy's Tweed brand is considered to be amongst the most recognizable so far. The brand was carefully designed to have a familiar

feeling; the "T" is not coincidentally similar to the "F" in the Ford brand. The other brands are targeted towards different demographics or use occasions.

### EXHIBIT IX

Canopy Growth's Cannabis Brands



Source(s): Company Documents

### Notable Investments/Partnerships

- Retail Distribution: Canopy believes distribution drives capacity, capacity alone does not. As such, the company wants to own the value chain all the way down to the consumer. As shown in the graphic below, Canopy has 28 retail outlets and is looking to expand. This strategy, at this geographic scale, is unique to Canopy.

## Exploring Cannabis Industry Players – Canopy Growth Corp. (Continued)

- Constellation Brands Ownership:** Canopy has long believed that beverages are the most lucrative alternative consumption opportunities. In November 2017, Constellation invested C\$245M in return for a 9.9% equity stake in Canopy. Later in August 2018, Constellation invested an additional C\$5B to increase their stake to almost 38%. Constellation also received warrants which, if exercised, would push their stake to >50%. The premium Constellation paid was roughly 51%. Given Canopy's interest in developing strong cannabis beverage brands, they have effectively given up control to one of the leading alcoholic beverage producers and marketers. So far, no cannabis drinks have been released in Canada. However, Canopy believes some drinks could be released as early as 2019.

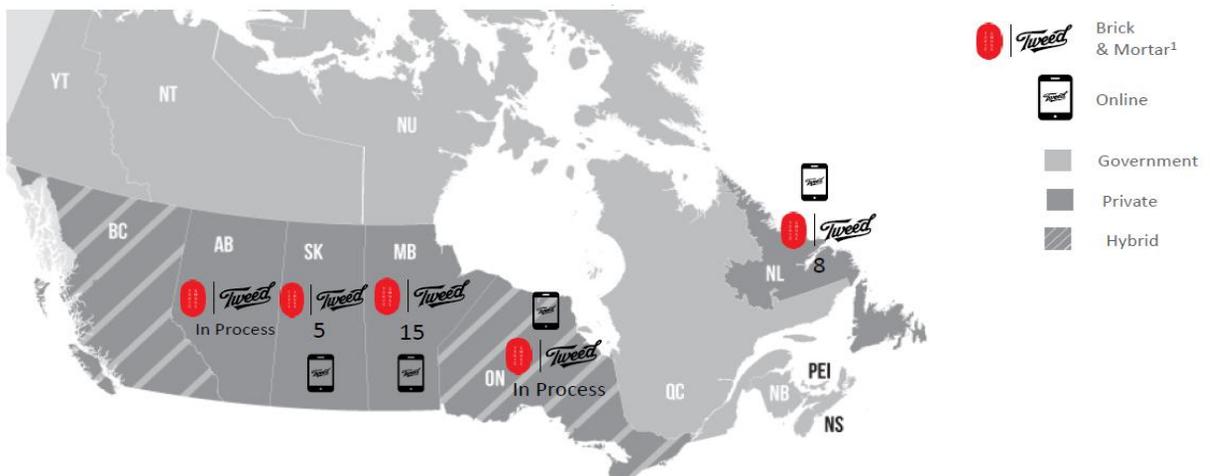
be the case with Molson Coors, which will be discussed later. However, Canopy seemed like the clear choice for Constellation given the alignment of their strategies.

The CEO of Canopy, Bruce Linton, is not concerned about the valuations of cannabis companies. He stated that, "by 2020 or 2021, there will be too much cannabis produced. If I'm still selling primarily an ingredient, I have completely dropped the ball. You want to transform it." It may be premature to call the Tweed brand as "strong," but the partnership with Constellation proves that the company is committed to not fall into the commodity trap.

It appears that when large beverage or tobacco companies attempt to enter the cannabis market, they shop around looking for the best deal. This seemed to

### EXHIBIT X

#### Canopy Growth's Retail Ambitions



Source(s): Company Documents

## Exploring Cannabis Industry Players – Tilray Inc.

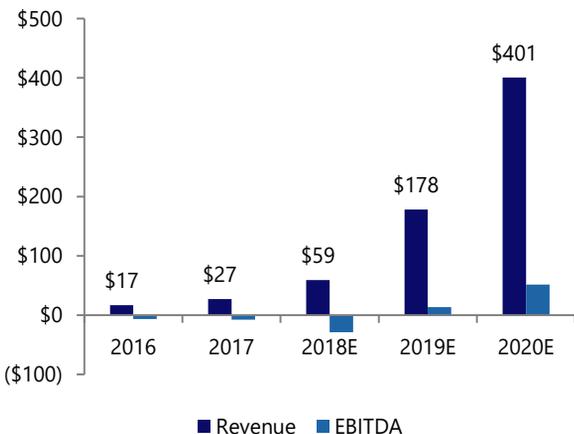
Tilray is a Canada-based but U.S. listed (NASDAQ:TLRY) cannabis company. The company is licensed to produce cannabis at its Canadian and Portuguese greenhouses.

In Canada, Tilray has deals to distribute medical cannabis to Shoppers Drug Mart and Pharmasave, as well as the major adult-use private/province-run outlets.

In the most recent quarter, Cannabis oils revenue outpaced revenue from dried cannabis. It is expected that as cannabis companies develop products which make consumption simpler, usage rates will increase. To a small degree, Tilray also sells smoking accessories.

### EXHIBIT XI

Tilray Revenue and EBITDA (000's)



Source(s): Capital IQ

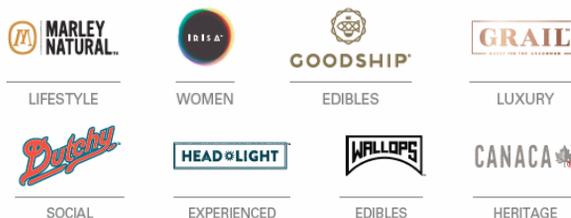
### Products

In the medicinal market, Tilray sells its products under the Tilray brand.

In the adult-use market, Tilray sells its products under a variety of different brands which are marketed for unique occasions.

### EXHIBIT XII

Tilray's Cannabis Brands



Source(s): Company Documents

### Notable Investments/Partnerships

- January 15<sup>th</sup> 2019: \$250M revenue sharing deal with ABG (own brands like Aeropostale and Nautica); primarily for CBD to make products like foot creams to sell in shoe stores. Tilray won't be the face of the brand they'll just supply the CBD. Basically, just products that can go alongside ABG's existing brands.
- December 19<sup>th</sup> 2018: Announced a partnership with AB InBev to research THC and CBD beverages. Each company will invest \$US50-100M.
- December 18<sup>th</sup> 2018: Partnership with Novartis for global medical cannabis sales (co-branded).
- September 18<sup>th</sup> 2018: First Canadian company to be granted permission by the DEA to export a cannabis product into the US. The product is to be used in clinical trials at University of San Diego. It's important because it's the first time a study cannabis drug produced in Canada has met FDA standards. Previously, the body that supplied cannabis for medical studies in the U.S. did not have a capsule product, which Tilray does.

Tilray does not agree with the other companies like Canopy giving up equity to larger companies. They think there is a long runway in this industry and they want to keep their independence.

## Exploring Cannabis Industry Players – Aurora Cannabis Inc.

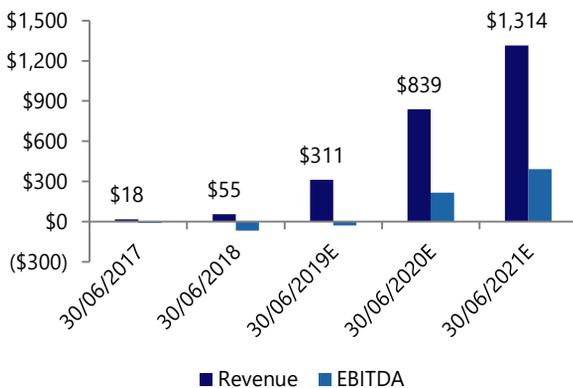
Aurora Cannabis is active in 22 countries, with a clear focus on establishing a larger presence in the EU. Of their 11 facilities, 2 are located in Odense, Denmark and are pending cultivation and sale licenses. Aurora now considers its principal businesses to be production and distribution in Canada, wholesale distribution in Germany, and production in Denmark.

is San Rafael.

However, Aurora is the largest Canadian cannabis company without a notable deal with a major alcohol or tobacco company. In August 2018, Aurora was passed over by Molson Coors for an investment. This deal would have placed Aurora in the running with Canopy and Constellation, but instead a small Quebec producer, HEXO, will reap the rewards.

### EXHIBIT XIII

Aurora Revenue and EBITDA (000's)



Source(s): Capital IQ

### Products

Aurora is also active in the medicinal cannabis space; the company has agreements to distribute to Pharmasave, PharmaChoice, and Shoppers Drug Mart.

In the adult-use market, Aurora has a vision for its product mix which includes edibles, beverages, and vapes. In fact, Aurora is the first LP to launch vape-ready cartridges. The goal is to sell increasingly higher margin products. Among its most recognizable brands

### Notable Investments/Partnerships

- **Growth:** Aurora's focus has been to acquire companies or enter into partnerships in order to expand its capacity and gain access to customers in new geographies.
- **Distribution:** Aurora Cannabis is based in Alberta and has developed a unique relationship with an Albertan liquor store chain. In May 2018, Aurora purchased a 25% ownership stake in Liquor Stores NA, now known as Alcanna. Aurora also holds warrants which could increase their stake to 40% by August 2019. Similarly to Canopy, Aurora wants to own the value chain as far as it can. Alongside its Wine and Beyond, Liquor Depot, Discount Liquor, and Brown Jug liquor stores, Alcanna plans to open 37 cannabis stores. The company has already opened 5 stores under the Nova Cannabis banner, which earned \$1.3M in their first 5 business days. The stores will carry Aurora's products as well as products from other LP's; so far there are no agreements to favour Aurora's products. For Alcanna, the decision to diversify with cannabis related to risks to the liquor business as well as their retail competency. Alcanna has seen that legalization in certain U.S. markets led to liquor sales dropping as much as 10%. Furthermore, Alcanna believes the retailing of cannabis will be much like alcohol, where they are competent. The CEO calls cannabis "a natural fit."

### EXHIBIT XIV

Aurora's Cannabis Brands



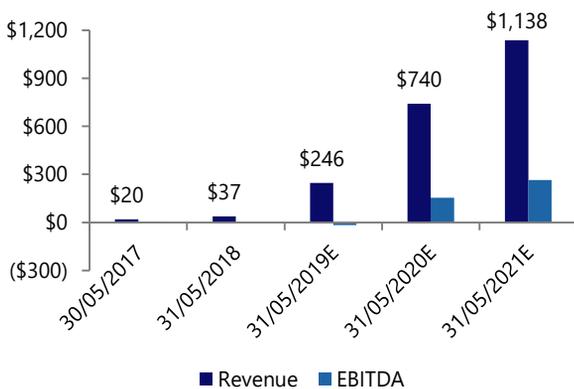
Source(s): Company Documents

## Exploring Cannabis Industry Players – Aphria

Aphria is the fourth largest Canadian cannabis producer by market capitalization. The company has a license to produce at a facility in Ontario, and a facility in British Columbia.

### EXHIBIT XV

Aphria Revenue and EBITDA (000's)



Source(s): Capital IQ

Aphria is known for having secured the first supply agreement with Shoppers Drug Mart. However, Shoppers now sells cannabis from other producers, including Aurora and Tilray.

### Products

Aphria has 30+ dried flower products, 7 oil products, and 4 softgel products (the softgels are pending Health Canada approval). However, Aphria has no announced partnerships to develop any of its products. The company even lists beverages as an in-house production product.

In the medicinal market, the company sells its products under the Aphria brand.

Aphria's adult-use brands include Solei, a brand marketed for novice users; RIFF, a brand for experienced users; Good Supply, a value-priced brand.

Aphria also acquired a B.C.-based producer, Broken Coast, to be able to sell "BC bud" at a premium price.

### EXHIBIT XVI

Aphria's Broken Coast Brand



Source(s): Shoppers Drug Mart, Ontario Cannabis Store

### Notable Investments/Partnerships

- **Distribution:** Perhaps due to capital limitations, Aphria has decided to not own the value chain all the way down to the consumer. The company has signed an exclusive partnership with Southern Glazer's. Southern Glazer's is the largest wine and spirits distributor in North America. The distributor represents brands such as Bacardi and Tito's in Canada, and will essentially act as Aphria's salesforce. The agreement offered Aphria 100% retail coverage across Canada since Day 1 of the Cannabis Act.

## The Future of Cannabis in Canada

The legalization of cannabis in Canada has resulted in a society in transition, and an industry poised for growth. Nevertheless, it is an industry whose dynamics will surely experience much rapid change in the near future. As a result, it is important to examine the future of the industry.

### Outlook on Regulation

For the near-term, much of the current Canadian regulation is expected to stay consistent; that cannabis products must be subject to strict regulatory controls. The way these controls are divided is that federal government bodies oversee commercial production and processing of adult-use cannabis, while the provinces and territories are responsible for providing oversight of distribution, wholesaling and retailing. This is expected to be no different with the current regulation up for question: the regulation of the production and sale of additional cannabis products, namely edible cannabis, cannabis extracts and cannabis topicals. Open for the public to share its opinions, current proposed regulation includes limits on THC content; the inclusion of nutritional information, plain, child-resistant packaging; a ban on mixing with alcohol or nicotine; and a ban on products that are appealing to kid including adding sugars and caffeine. The government attends that proposed regulations align with their overarching goal of keeping cannabis out of the hands of youth and protecting public health and safety. Edibles are expected to be on the legal market by October 17, 2019, and it could be a lucrative business.

In the long-term, it is expected that legalization will legitimize consumption and diminish the stigma that surrounds it today. Canada been able to effectively develop strong, thriving industries based on tightly regulated, controlled substances such as beer, wine, and spirits. As a result, more freedom in this market will come as regulations are expected to loosen up over time, keeping safeguards in place while allowing more "brand awareness. The government will continue playing a key role in ensuring public safety.

### Outlook on Industry Trends

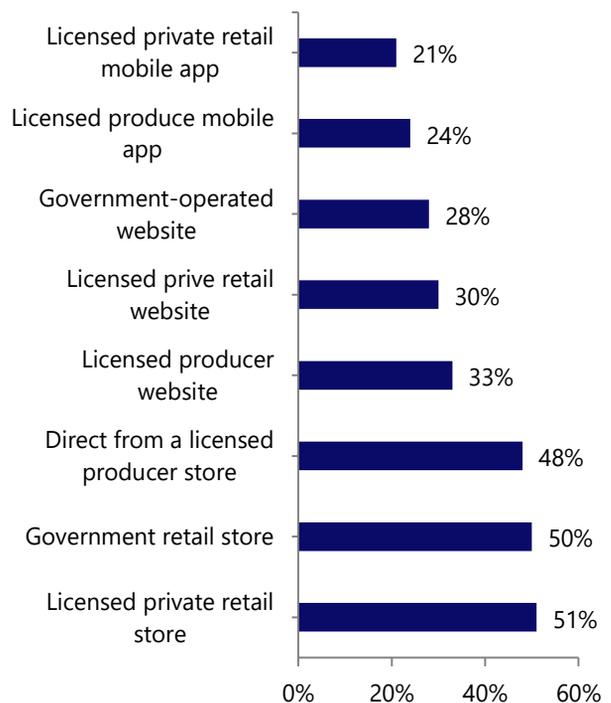
#### Consumer Trends

Cannabis consumption will become a normalized activity more quickly than many might have anticipated. As a result players must be aware of forward-looking consumer trends.

*Distribution preferences:* Almost half (47 percent) of all recreational products are expected to be bought from physical locations. Nevertheless, roughly a third (35 percent) of cannabis consumers are also interested in buying online and mobile channels. This interest buying online is understandable, given the stigma that

#### EXHIBIT XVII

Consumer preferred legal purchase channels



Source(s): Deloitte

## The Future of Cannabis in Canada (Continued)

surrounds cannabis consumption; this option enables customers to maintain their privacy.

*Product preferences:* There exists a strong appetite for edible products and this is expected to be a booming product category when legalized. Nearly two-thirds (64 percent) of current and likely consumers are aware of cannabis-based baked goods, such as brownies, and 51 percent say they're interested in trying them. Overall, six out of 10 cannabis customers will choose to consume edible products. For current consumers, edibles could comprise 18 percent of their overall intake after legalization, up from 14 percent today.

*Customer experience:* Canadian consumers have high expectations, and their needs and behaviours are constantly evolving. Like any other retailer, those selling cannabis will need exceed expectations to succeed. By far, the most critical feature for cannabis stores is having staff with strong product knowledge. For online stores, retailers' are expected to provide free shipping, clear pricing, and robust cybersecurity.

### Producer trends

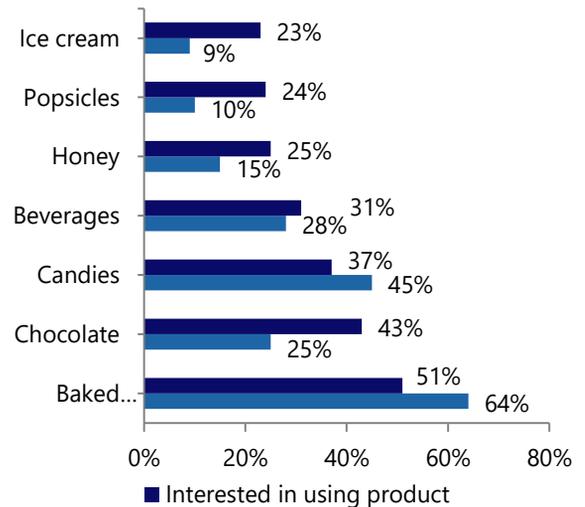
*Downstream production:* The market's growing sophistication will see profit margins move downstream, away from growers to value-add operations which include extractors, who blend products to consistent specifications, and processors, who use the cannabis buds and oils to create foods, drinks, creams and other innovative products.

*Product offerings:* Expanding government regulations around cannabis product forms will enable companies to create a wider variety of products and develop distinguished offerings.

*Expansion opportunities:* The internationalization of cannabis will offer successful producers lucrative expansion opportunities. However, the export market will also bring new challenges and companies will have to find partnerships and or joint ventures essential for success. Nevertheless, Canadian players have the potential on the global stage.

### EXHIBIT XVIII

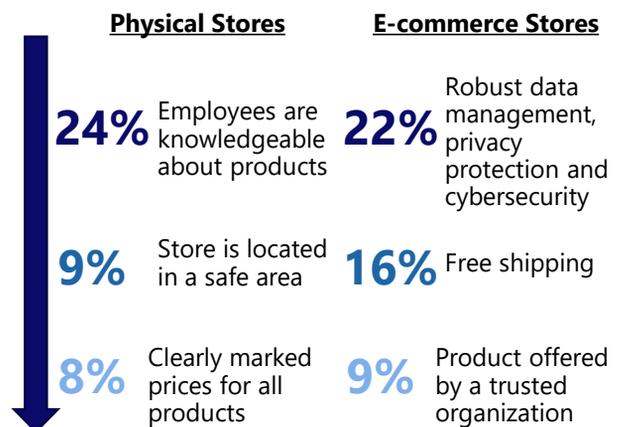
Consumer interest in edible products



Source(s): Deloitte

### EXHIBIT XIX

Top consumer shopping preferences



Source(s): Deloitte

## The Future of Cannabis in Canada (Continued)

*Investor pressure and consolidation:* As the market becomes established, institutional investors will step in and expectations will change. Companies will find themselves under greater pressure to deliver profits. Those that prove unable to adapt to this new reality could find themselves pushed towards mergers and acquisitions. Canadian cannabis companies have been involved in at least 97 announced acquisitions and investments with a combined value of \$8.06 billion in 2018. As a result, consolidation has been a major trend within the industry that is expected to continue.

### Adjacent industry trends

The arrival of well-financed participants from adjacent industries, from downstream producers to technology startups, will not only boost competition in the marketplace, but also raise the standard of products and services. With so many emerging players in the field, manufacturers will be forced to move away from a vertically-integrated business model.

### **Outlook on Future Strategy**

To succeed in this rapidly evolving industry, companies will need to grasp the realities of the marketplace and enact a focused and forward-looking strategy. These sophisticated strategies must meet emerging consumer demands, ongoing investor expectations and successfully compete against the black market.

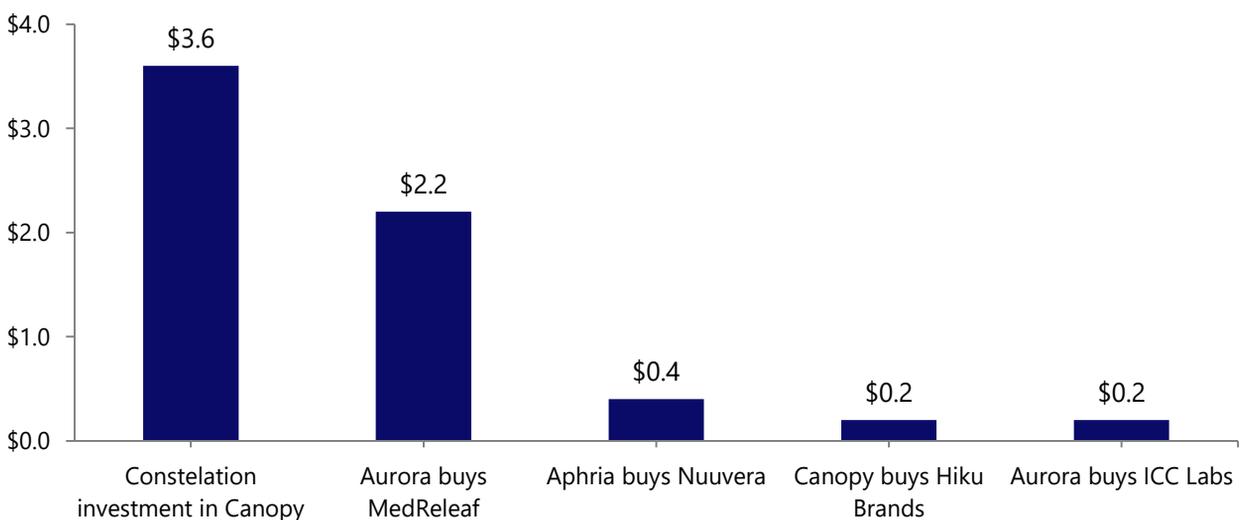
### Customer-facing strategy

*Adapting to customer needs and demands:* Consistent experiences, and deep customer insights will play a vital role in ensuring Canadian cannabis retailers thrive. For example, having a wider variety of products and develop distinguished offerings as government regulations expand will be critical.

*Security strategy:* Similarly, it is vital that cannabis organizations adopt a multi-disciplinary, enterprise-wide approach to help identify, assess, and address the dynamic security risks they face in both the physical world and the

## EXHIBIT XX

Largest cannabis transactions in Canada in 2018 (billions)



Source(s): Bloomberg

## The Future of Cannabis in Canada (Continued)

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online domain. Security is a critical customer need and will be critical to establishing brand trust.

*Retail strategy:* Retail fundamentals will still apply: customer insight and data is critical. Cannabis companies will need to execute today's retail fundamentals just as effectively as those in more traditional sectors. Consistent and engaging omnichannel experiences, deep insights derived from customer and retail network analytics, and effective security and product integrity will be key to ensuring they thrive. As the cannabis industry matures and stabilizes, customer experience will be of paramount importance. In the future, location, online and physical security, and product variety will become table stakes. Retailers will undoubtedly want to differentiate themselves by moving into discount or premium market segments and delivering unique, seamless experiences in-store and online.

*Brand development:* As the industry matures, stigma surrounding cannabis consumption weakens, and government regulations loosen, the introduction of brands within the cannabis space is highly likely, similar to how alcohol brands function. It will thus be critical for cannabis companies to invest in brand development early.

### Internal Operations Strategy

*Capability and system enhancement:* Producers and retailers that are able to secure the supply chain, protect and analyze customer data, and promote public health and safety will be well positioned to achieve a competitive advantage. This could be achieved through partnerships or acquisitions of players or start-ups from other industries.

*Business model redesign:* Vertically integrated producers must assess and make critical strategic choices on their own value proposition to sustain their current competitive advantage. As additional production capacity is brought online and cannabis quickly becomes a commodity product, companies

should isolate and focus on areas of the value chain where they can differentiate and entice consumers into new behavior patterns. Participating in the successful diffusion of business models across the value chain will separate the winners from the losers.

*Expansion and consolidation strategies:* It will be critical for companies to be aware of the merger and acquisition activity in the industry. Synergies and efficiencies can be achieved from participating in consolidation, especially for vertically integrated producers. Similarly, expansion opportunities present the potential to achieve early market share on the global stage.

### Implications and Considerations

The cannabis industry in Canada is in consistent flux as regulations evolve, customer expectations rise, and competition is fierce. To be successful, executives are going to have to quickly accept that the market they entered is rapidly maturing. In response, they will need to broaden their thinking to carve out favourable opportunities. They must identify market gaps and adapt their business to capitalize on them.

One key to success at this stage is recognizing that the cannabis marketplace will remain fluid for some years, so businesses must remain flexible to change. At the same time, fundamental industry characteristics are present and will be expected to remain critical. Strategy aspects such as brand development, strong retail strategies, and adapting to customer needs are universal. Similarly, seeking opportunities within and outside the Canadian market to drive efficiencies and develop a competitive advantage are also consistent among all industries.

As recreational consumption will eventually become normalized and mainstream, it is an industry that is being built in real-time, which presents a unique learning and investing opportunity.

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