

Canopy Growth Corp. (WEED-T) Supply Matters Addressed; We See A String Of Catalysts Ahead

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Vahan Ajamian, CPA, CA, CFA

Analyst - (416) 643-3879

vajamian@beaconsecurities.ca

- Canopy reported Q3/FY17 results and we subsequently hosted numerous marketing meetings with institutional investors.
- **Revenue of \$9.8MM was below our estimate and consensus of \$10.9MM** (up 15% sequentially). The miss was primarily a matter of revenue timing. While the company 'only' sold 1,245 kg in Q3/FY17, it harvested 5,246 kg. ~3,700 kg came from a record harvest at Tweed Farms and normal course procedures (QA/QC etc.) to release this harvest resulted in a shortage of supply for sale throughout the quarter – particularly for moderate to high THC strains. **We estimate the company left \$2MM to \$3MM on the table due to this lack of supply.** Inventory at the end of Q3/FY17 doubled to \$50.6MM and this is already being pushed out to patients. **The company added 10 new strains to the Tweed store on February 1, 2017, and disclosed that sales on that day were \$1MM.** While we don't believe this represents the company's current run rate (pent up demand being absorbed), in our view, this illustrates the degree to which the company's infrastructure has been built out to scale and what it is capable of.
- With both higher prices and lower costs per gram, adjusted gross margins of 68% exceeded our expectations, although the EBITDA loss was larger than we had forecast.
- **In our view, management is addressing the matter of the Mettrum recall head on.** Mr. Bruce Linton, Canopy's CEO, published an open letter yesterday highlighting the operational and personnel changes to bring Mettrum's procedures up to Tweed's standards. With Canopy now in charge, it declared "that a recall like this will never happen again". Mettrum's patients appear to be sticking around (the business acquisition report filed last night disclosed that Mettrum's sales grew 10.5% sequentially in the December quarter). We estimate the combined company's patient count at ~51K, and we believe it could double this year.
- With a strong presence in Ontario and recent entry in to Quebec, through the acquisition of Vert Medical, **we view an investment in the West** (likely BC or AB) **as the next step in building out a national cannabis production and distribution network.**
- Germany is expected to outline its license application process in two or three months. **We believe Canopy will aggressively try to secure one of the first licenses issued** and, in our view, already having met the standards to be on the shelf today and having boots on the ground present clear advantages. Ireland appears to be the next country coming online.
- The company is very bullish on the prospects for new product formats. In particular, believing that authorization from Health Canada is close, Canopy has already set up an encapsulation room at Smiths Falls and built up a meaningful amount of inventory of gel capsules. We believe that being a first mover out of the gate for this format, which looks more like traditional medicine, could help cement the company's status as the leader in the industry.
- Following a series of announcements, **Canopy is unlocking new markets almost daily, and we see several potential catalysts for the company's shares in the coming weeks.**
- **We maintain our Buy recommendation. Our target price rises to \$15.00** (from \$14.50).

Q3/FY17 Results & Marketing

BUY (Unch) **\$15.00** (From \$14.50)

Previous Close	\$12.28
12-month Target Price	\$15.00
Potential Return	22%
52 Week Price Range	\$2.40 - \$17.86

Estimates

YE: Mar 31	FY16A	FY17E	FY18E
Revenue (\$MM)	\$12.7	\$40.2	\$99.4
FD EPS	-\$0.05	-\$0.05	-\$0.13

Valuation

	FY16A	FY17E	FY18E
EV/Sales	144.8x	45.7x	18.5x
P/E	nmf	nmf	nmf

Stock Data (MM)

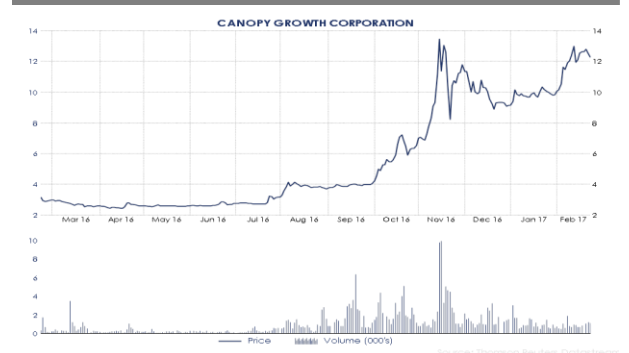
Shares Outstanding	
Basic	157.9
FD	167.5
Market Cap	
Basic	\$1,938.6
FD	\$2,057.0
Net Debt	-\$99.2
Enterprise Value	\$1,839.4

About the Company

Canopy Growth is in the business of producing and selling medical marijuana in Canada and is positioning itself for the pending legalization of the recreational market. The company's brands include: Tweed; DNA Genetics; Leafs By Snoop; Bedrocan and Mettrum. Canopy is headquartered in Smiths Falls, Ontario.

All figures in C\$ unless otherwise indicated.

Stock Performance



Q3/FY17 Highlights

Exhibit 1. Q3/FY17 Highlights

Quarter Ended	Actual	Beacon Est.	Q3/FY16 Dec-15	Q2/FY17 Sep-16	% Change	
	Q3/FY17 Dec-16	Q3/FY17E Dec-16			Y/Y	Q/Q
Registered Patients	29,000	34,268	8,289	24,477	249.9%	18.5%
kg Sold	1,245	1,542	462	1,169	169.8%	6.5%
Price Realized / g	\$7.36	\$7.10	\$7.34	\$7.01	0.3%	5.0%
Revenue From Marijuana Sales (000's)	\$9,164	\$10,949	\$3,388	\$8,197	170.5%	11.8%
Consolidated Revenue (000's)	\$9,752	\$10,949	\$3,481	\$8,498	180.1%	14.8%
Adjusted COGS / g	\$2.47	\$2.75	\$2.29	\$2.77	7.9%	-10.8%
Adjusted Gross Margin %	68%	61%	70%	62%	-117 bps	658 bps
Adjusted Gross Margin (000's)	\$6,677	\$6,708	\$2,424	\$5,259	175.4%	27.0%
Sales and Marketing (000's)	\$3,780	\$3,394	\$1,372	\$2,810	175.5%	34.5%
Research and Development (000's)	\$439	\$635	\$192	\$503	128.6%	-12.7%
General and Administration (000's)	\$4,043	\$4,708	\$1,962	\$4,031	106.1%	0.3%
Overhead / Revenue	85%	80%	101%	86%	-1657 bps	-170 bps

Source: Company reports, Beacon Securities.

- Q3/FY17 was the last full quarter before the acquisition of Mettrum (closed January 31, 2017).
- The company sold 1,245 kg and kg equivalents of marijuana in Q3/FY17. This was below our forecast of 1,542 kg.
- Revenue from marijuana sales of \$9.2MM was below of our \$10.9MM forecast. **Total revenue of \$9.8MM was below our \$10.9MM forecast and consensus of \$10.9MM.**
- While the top line was below our expectations, the underlying profitability of sales outperformed. The **average selling price of \$7.36/g exceeded our forecast of \$7.10/g**. Concurrently, **adjusted cost of goods sold of \$2.47/g was below our forecast of \$2.75/g**. Adjusted gross margins of 68% well exceeded our 61% forecast.
- EBITDA was \$-4.6MM, representing a larger loss than our \$-2.0MM forecast.

Timing A Major Factor In Supply/Demand Imbalance During Q3/FY16 – Issue Has Since Been Remedied

- While the company 'only' sold 1,245 kg in the quarter, it **harvested a record 5,264 kg**. Much of this (~3,700 kg) came from the seasonally large harvest at Tweed Farms.
- Tweed Farms produced very large plants (average yield of 800+ g per plant). While yields will vary by season (i.e., plants grown in the winter will likely be smaller), management believes it can still increase the yield in subsequent harvests by increasing the density of plants. Regarding scalability, management was of the view that once it

knows how to harvest 5,000 kg, it can scale up to harvesting 20,000 kg in the future.

- Supply available for sale during Q3/FY17 was limited by normal course procedures to fully test the record harvest (i.e., product release process, quality control / quality assurance procedures).
- Therefore, demand largely exceeded supply throughout the quarter. **We estimate the company left \$2MM to \$3MM on the table in terms of unsold product due to these supply shortages / lack of sufficient variety.**
- As explained by CEO Bruce Linton on the company's conference call "if you have a \$6 or \$9 moderate to high THC, that sells, and we really didn't have that in the quarter almost ever." Patients preferring these strains / price points comprise approximately one-third of the company's customer base.
- **Inventory at the end of the quarter essentially doubled sequentially to \$50.6MM** (from \$27.6MM), setting the company up well for future sales, in our view. Whatever inventory Canopy picked up with the acquisition of Mettrum was likely not significant (Mettrum's inventory as at December 31, 2016, was \$5.4MM and we suspect at least some of it may not have been usable).

February 1, 2017, Sales Show What The Company Has Scaled Up To

- While growth during January was slower (i.e, similar to Q3/FY17), the company **clearly turned the corner in February** with supply constraints having clearly been significantly alleviated.
- While Tweed typically only had five or six strains and one oil available during Q3/FY17, it added 10 new products to the store on February 1, 2017, including DNA-Certified and Leafs by Snoop strains which retail for \$9 to \$12 per gram. February 1, 2017, was also the company's first day post the Mettrum acquisition. One strain added in February consists of 27% THC, an offering the company did not have essentially throughout Q3/FY17.
- The company disclosed that it **generated \$1MM in sales on February 1, 2017**. For context, the company had its first \$1MM quarter less than two years ago, its first \$1MM month a year ago, and now its first \$1MM day. To be clear, we do not believe this figure is indicative of the new run rate of the company (management indicated that sales in subsequent days were lower). However, in our view, this illustrates the extent to which Canopy has been built to take advantage of scale and what the company's current built out infrastructure is capable of.
- Bruce Linton on the Q3/FY17 conference call proclaimed that "**now it feels like we're back to the rate of growth that we kind of expect for the Canopy Group.**" (emphasis ours)

- Going forward, the company views the biggest risks to the company to be:
 - 1) Having #1 market share come legalization and promptly running out of product (hence the current emphasis on growing capacity to be ready).
 - 2) Insufficient education of the public, particularly regarding newer forms of cannabis, whereby a user takes too much the first time – and doesn't return.

Take-Aways from Marketing Meetings

The West Wants In!

- Canopy has made a number of strategic acquisitions and built out a production and distribution network in the most populous provinces in the country.
- All of the company's current production is in Ontario (i.e., Tweed, Tweed Farms, Bedrocan, Mettrum (Bowmanville, Creemore and Barrie)).
- In November 2016, Canopy entered the Quebec market via the acquisition of Vert Medical, an ACMPR applicant based in Drummondville. Vert leases a 7K sq. ft. indoor facility on 90 acres of land on which it can build in the future. We understand that Canopy has applied its operational and regulatory know-how and made meaningful improvements to the site. Accordingly, **we believe licensing of Vert may be close**. We suspect the SAQ may have the exclusive right to distribute marijuana in the province (its union has reportedly launched a public relations campaign in favour of the idea). In such a scenario, we would envision the organization significantly promoting product grown in Quebec. With Hydrothecary the only Quebec-based LP currently, we believe Vert could be very well positioned once it obtains Health Canada certifications.
- In our view, **Western Canada is the main missing piece to building out a national production / distribution network**. Accordingly, we would not be surprised to see the company make an acquisition in Alberta or British Columbia in the near-term. This could be an existing LP (there are eight in BC, 1 in AB, 2 in SK, and 1 in MB) – or we could envision another Vert-like situation where Canopy acquires a late stage applicant and uses its resources to get the company 'over the hump' to a license.

International Presence Still Very Much In Focus

Germany

- The German Bundestag passed a decision to legalize medical cannabis on January 19, 2017 (refer to our industry note dated January 20, 2017). We believe this decision will significantly expand

what was previously a very restrictive medical regime that limited patient authorization to ~1,000 German citizens – and unlock the potential market of 82MM people.

- Canopy was the first North American producer (second globally) which received German authorization to export medical cannabis to the country. The company has made multiple shipments to Germany, totaling 130 kg to date.
- Per Mr. Linton on the Q3/FY17 conference call, “over the next month or two, I would be kind of surprised if they didn’t begin to have a process by which companies could make application to become a licensed producer.”
- We expect Canopy to make a major push to acquire one of the first licenses issued in Germany. We believe the company has built-in advantages in that:
 - It has already met the standard for sale in the country;
 - It already owns a company that has licenses to possess and transport marijuana (MedCann, acquired in November 2016);
 - We believe the Health Canada licensing process is largely held as the gold standard for other countries looking to establish such a framework – and that Canopy in particular has been in frequent contact with German authorities.

Other Countries

- Brazil, although in an earlier stage than Germany, was also a recurring theme during investor meetings. Similar to the Canadian experience, the courts have made medical cannabis technically legal in the country already; however, there is no current legal domestic production. Management is already monitoring the market for opportunities.
- Ireland looks like it is also transitioning towards legalization. We were left with the sense that this could be the next market to open up for Canopy.
- Australia is also looking to fast track importation of medical marijuana to deal with a supply shortage until local cultivation (legal since October 2016) ramps up to meet demand.

Mettrum Update

- Mettrum's recent recalls have clearly left a mark on the company's reputation. Management disclosed that the completed transaction was a result of the fourth time Canopy approached Mettrum pitching a combination of the two companies. The valuation Canopy was willing to offer was lowered by the recall and with Canopy having accelerated significantly faster than Mettrum, Canopy shareholders ended up owning 77.7% of the combined company – which we believe was meaningfully higher than previous negotiations may have contemplated. We understand Health Canada closed the recall file before the transaction closed.

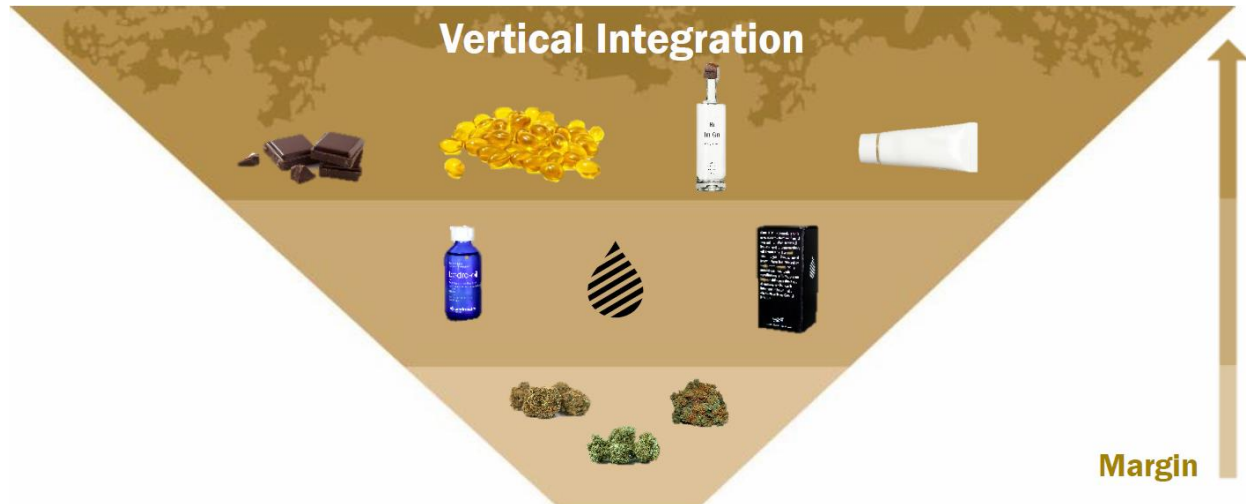
- Total cost of the recall (including destroying certain product) was \$~800K. This amount was incurred by Mettrum prior to the combination.
- Bruce Linton published an open letter yesterday regarding Mettrum's transition. In our view, the company pulled no punches – expressing its view that “the application of pest control products not registered for use on cannabis at Mettrum was inexcusable.”
- The letter also described the steps that Canopy has since taken to assure customers that a reoccurrence of Health Canada violations would not take place. These steps included numerous process and personnel changes to bring practices in-line with procedures used at Tweed and Tweed Farms, and infrastructure modifications are coming. The Mettrum recall took place prior to Canopy's ownership, and the company pledged to “Mettrum customers that **a recall like this will never happen again**” (emphasis ours).
- Management indicated on the Q3/FY17 call that Mettrum's patients appear to be sticking around. According to the business acquisition report filed last night, despite its issues, Mettrum still generated 10.5% sequential revenue growth for the quarter ended December 31, 2016. Management indicated that there was very little overlap among the companies' patients. We estimate **the company's combined patient count to be ~51K currently and management believes it can double it this year.**
- Mettrum will focus on the medical and natural health markets. Management described Mettrum's positioning as being similar to vitamins situated in the middle a spectrum consisting of Bedrocan on one end (very heavily medically focused – think Buckley's) and Tweed, which will be the company's recreationally focused brand post legalization. Given this positioning, we suspect the company will look to push the Mettrum brand in Germany as well.
- Management was optimistic about the Mettrum Originals business it inherited via the acquisition. Mettrum has a license to produce industrial cannabis (hemp) in its production facility in Barrie, Ontario. Branded under the Mettrum Originals product line since September 2015, Mettrum offers 30 SKUs of hemp products (seeds, bars etc.) which are available across ~2,000 stores in Canada and the U.S. On November 1, 2016, Canopy acquired a majority stake in Groupe Hemp, which is licensed by Health Canada to cultivate hemp and extract oil from hemp seeds. The company operates the website hemp.ca. We believe the management will look to fuse these two hemp brands together.

New Formats May Start Rolling Out Soon

- While Canopy will always have significant production of raw cannabis and sell it to those wanting it in that form, the company's goal is to create a wide selection of value added products in different formats, as permitted by government regulations – which should be able to command a higher margin (see Exhibit 2 for examples). In keeping with the global scalability of the company's plans, once the company has spent the time and money to perfect a certain product in one

country, it can then also start production in other jurisdictions where it is allowed.

Exhibit 2. Canopy's Product Roadmap



Source: Company reports.

- Gel capsules are the format management seems most enthusiastic about. Believing that an authorization from Health Canada allowing their sale is very close, the company has set up an encapsulation room at Smiths Falls and we understand it has already built up a meaningful amount inventory ready for sale once it receives the green light from Health Canada. Gel capsules look and feel like traditional medicine, offer consistency (same mg per mL) and could use specific strains to target specific conditions – attributes we believe would help broaden adoption among physicians and pharmacists. Simultaneously, we believe that being the first to market with a gel capsule would cement Canopy's status as a leader in the sector, and go a long way in turning the company's strategy outlined in Exhibit 2 above into a reality.
- Management believes vape pens will also soon be authorized for sale by Health Canada and expects topical creams to follow at some point. Canopy announced an MOU with Namaste Technologies Inc. (N-C, not covered) to "form multi-point working arrangements..." and explore "...the development of new delivery devices for the consumption of cannabis." Although broad, one specifically mentioned component of the partnership was that **Namaste will support the development of Canopy branded vaporizers and accessories.**
- **Canopy seems to be venturing into new cannabis markets almost daily.** Just this week, in addition to the MOU with Namaste mentioned above, FORIA, award-winning cannabis-infused personal lubricant designed for female sexual health, announced a collaboration with Tweed to make its product available in Canada. Also, Canopy announced on Wednesday that Tweed will be just the second LP in

Canada to sell seeds to authorized patients preferring to grow their own medicine at home.

- Recall that Canopy also owns 46.15% of Canopy Health Innovation, a cannabis research incubator, which will develop and research clinically ready cannabis drug formulations and dose delivery systems.

Path To Legalization

- The majority federal government has committed to introduce "legislation on the legalization and strict regulation of marijuana in spring 2017". While there has been speculation in the market that legislation may be tabled on April 20, 2017, management was of the view that it could be tabled before this date to ensure sufficient time to complete the legislative process before the summer recess.
- It appears that different provinces are more engaged and actively preparing for legalization, and therefore, recreational sales may start in some provinces earlier than others (i.e., there may not be a uniform national start date). We were left with the impression that Ontario may be among the first movers.

We See A String Of Catalysts Ahead

- **Imminently – More large U.S. investor interest.** We believe Canopy is attracting the attention of some very large U.S. fund managers who are looking to participate in the upside in the industry. As there is a lack of U.S. public companies of any meaningful size, and given Canopy's status as the global leader in the sector, we believe these funds are increasingly looking at making investments in the company. Recall that management indicated at its shareholder meeting last month that it is seeing many more large U.S. funds making day trips to tour its facility recently.
- **Likely In A Few Weeks – Health Canada authorization of gel capsules** (and potentially vape pens).
- **March – Addition to the S&P/TSX Composite Index.** We expect Canopy to be added to the index as part of its quarterly rebalancing (announcement between March 1 and 14, effective March 17, 2017). We anticipate that index inclusion would significantly widen the company's institutional investor base.
- **March – Germany's medical marijuana law takes effect.**
- **April – Germany likely to begin the process of accepting applications for cultivation licenses.**
- **Spring 2017 – Introduction of legislation** – should cement the fact that 'legalization is happening' in the minds of investors and be accompanied by significant media coverage.

Exhibit 3. Q4/FY17 Forecasts

Quarter Ended	Beacon Est.	Q4/FY16	Q3/FY17	% Change	
	Q4/FY17E Mar-17	Mar-16	Dec-16	Y/Y	Q/Q
Registered Patients	53,279	11,630	29,000	358.1%	83.7%
kg Sold	1,998	700	1,245	185.3%	60.5%
Price Realized / g	\$7.50	\$7.16	\$7.36	4.7%	1.9%
Revenue From Marijuana Sales (000's)	\$14,985	\$5,015	\$9,164	198.8%	63.5%
Consolidated Revenue (000's)	\$14,985	\$5,042	\$9,752	197.2%	53.7%
Adjusted COGS / g	\$2.50	\$2.69	\$2.47	-7.1%	1.2%
Adjusted Gross Margin %	67%	63%	68%	403 bps	-180 bps
Adjusted Gross Margin (000's)	\$9,990	\$3,158	\$6,677	216.3%	49.6%
Sales and Marketing (000's)	\$5,814	\$2,399	\$3,780	142.4%	53.8%
Research and Development (000's)	\$712	\$281	\$439	153.3%	62.1%
General and Administration (000's)	\$6,593	\$2,561	\$4,043	157.4%	63.1%
Overhead / Revenue	88%	104%	85%	-1640 bps	283 bps

Source: Company reports, Beacon Securities estimates.

- We are forecasting Q4/FY17 revenue of \$15.0MM and EBITDA of \$-3.1MM.

Maintaining Buy, Raising Price Target To \$15.00

- Our \$15.00 target price for Canopy (was \$14.50) is derived by a DCF. Highlights from our DCF include: achieving 24% market share by FY22 (i.e., 176 mt); revenue realized per gram rising to \$8.50 shortly after legalization, then falling to \$7.00 longer-term; adjusted cost of goods sold falling to \$2.10 longerterm; a discount rate of 10%; and a zero terminal growth rate post FY24.

Exhibit 4. Highlights Of Our DCF

	Mar-18 Q4/F18E	Mar-19 F2019E	Mar-20 F2020E	Mar-21 F2021E	Mar-22 F2022E	Mar-23 F2023E	Mar-24 F2024E	Terminal Value
(000's - expect share prices and share count)								
Revenue	\$29,922	\$209,353	\$417,114	\$761,747	\$1,383,105	\$1,843,925	\$2,002,508	
Adjusted Gross Margin	\$21,241	\$151,473	\$304,248	\$553,998	\$995,810	\$1,305,931	\$1,401,756	
EBITDA	-\$1,709	\$2,897	\$41,607	\$137,836	\$317,190	\$476,972	\$540,677	
Net Income	-\$4,773	-\$9,982	\$21,359	\$92,984	\$227,495	\$348,119	\$397,492	
Free Cash Flow	-\$13,138	-\$49,612	-\$24,116	\$38,890	\$163,833	\$316,279	\$381,252	\$3,812,517
PV of Free Cash Flow	-\$12,829	-\$45,759	-\$20,427	\$28,984	\$112,505	\$198,404	\$217,716	\$2,003,601
Discount Rate	10%							
Total PV of FCF	\$2,482,195							
Net Cash as at Valuation Date (Q3/FY18)	\$78,024							
Total Value	\$2,560,219							
Shares outstanding at Valuation Date	171,086,894							
Value per Share (Rounded)	\$15.00							
Current Price	\$12.30							
Return	22%							

Source: Beacon Securities estimates.

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As at January 31, 2017	#Stocks	Distribution
Buy	70	81.4%
Speculative Buy	8	9.3%
Hold	3	3.5%
Sell	0	0.0%
Under Review	5	5.8%
Tender	0	0.0%
Total	86	100.0%

Buy	Total 12-month return expected to be > 15%
Speculative Buy	Potential 12-month return is high (>15%) but given elevated risk, investment could result in a material loss
Hold	Total 12-month return is expected to be between 0% and 15%
Sell	Total 12-month return is expected to be negative
Tender	Clients are advised to tender their shares to a takeover bid or similar offer

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