



# GENERATION ETFs - Season 2 Ep. 2: John Zamparo (Part 2)

## **Mark Noble**

Hello, and welcome back to part two of our discussion with John Zamparo, Director of Research at CIBC Capital Markets, who covers the cannabis industry for CIBC. We're going to continue our discussion about some of the key opportunities in this growing space as part of our 420 edition of the podcast. So John will go over a few more of the opportunities that we're seeing. We'll really probably get into more so what we're seeing on the U.S. side of things, and where the opportunities might be with some of the key areas such as CBD, legal hemp production, as well as we'll talk about some of the risks, right. While things have been great in the marijuana industry, there are some bumps in the road that could present themselves over the next few months and John's going to cover that all with us.

## **Mark Noble**

I'm assuming that when you're looking at the, you know, at the quarterly reports, so the revenue's then the big number that's jumping out, you're looking for the revenue growth.

## **John Zamparo**

Revenue I would say is important. Market share is important. Gross margin. And I would say, you know, gross dollars per gram can matter. Not as much at the moment just because so many companies are still in ramping mode.

## **Mark Noble**

Right.

## **John Zamparo**

But I always like to say, these quarters do have relevance. If they are inordinately good or bad, they you have relevance. But if you're, if you're kind of on par and if there's not anything too remarkable, we don't want to pay too much attention to them. I mean it's that, you know, analogy of they're not handing out gold medals at the 10 meter mark in a hundred meter sprints.

## **Mark Noble**

Right.

## **John Zamparo**

And I think that has some relevance here. But that said, there are, there are quarters that certainly generate headlines for the right reasons because companies are either way ahead or way behind versus expectations and that can create out sized movements on any given day. So we certainly do pay attention to quarters, but we're also cognizant of the fact that you know, you can't make a two to five year judgment unaccompanied based on one particular quarter.

## **Mark Noble**

And then I guess one of the other issues that we run into in this industry is particularly when we launched our ETF, the Horizons Marijuana Life Sciences Index ETF, we had a lot of the providers coming to us with their traditional IR materials, investment relations materials, and that, you know, the first thing is they are, they're low cost producer, right? And there's this whole idea that on multiple in the revenues are gross profit margins of being a low cost producer. But I have yet to come up with anyone who can, tell me who is the low cost producer or how I would even go about determining that from looking at the balance sheets and inventory numbers, even though it seems to be used as a key marketing piece. So how, who is the low cost producer? How the heck do you even figure that out?

## **John Zamparo**

Yeah, you won't get an answer from me on that. And there's a specific reason for that. So I fully echo what you're saying. I mean every, every company I talk to, seemingly, not every, but I would say 75% of the companies say we are either the low cost producer or we're a low cost producer and they tout their low cost production. I find it just a little bit comical and I think the fixation on low cost production stems from our Canadian investing history, right? And we have this basis of mining and of commodities. And we think of it as a resource. We think, you know, how much of this do you have in the ground? How much does it cost to extract it? What can you sell it for? Who can to sell it to? We treat it like gold or we treat it like copper. And this is very, very different from that. And I think investors are looking at the wrong metric if they're purely looking at who is the low cost producer.

## **Mark Noble**

Right.

## **John Zamparo**

I think even the most astute investor in the world in beverages or tobacco or pharmaceuticals couldn't tell you who the lowest cost producer is. For one, because it doesn't particularly matter. And for another reason, because those companies don't produce their own goods, they buy it from farmers, typically, or at least from another party. So I mean, I do kind of chuckle when I see that in metric thrown around. That said, this

doesn't mean margins are irrelevant, right? I mean, low cost production folds into gross margin and EBITDA margin eventually. And then those are very relevant.

## **John Zamparo**

So we do look at those measures. I mentioned early on in the industry, you know, there's some puts and takes on that. And any one given quarter can look good or not so good depending on if the company's in ramp mode or if they had a lot of inventory built up, it can change things. But I think the key factor is to look two to three years down the line, about who can generate the most EBITDA dollars and who can generate very good gross margins and EBITDA margins rather than purely relying on costs. And when you think about, I always like to think about the tequila industry. You think about, you know, if you're paying a thousand dollars for a bottle at retail, and I would never do that, and I wouldn't advocate anybody to do that, but you don't care if it costs them a hundred or two hundred dollars to make it because they're making eight hundred dollars on the gross margin side. So I think the obsession with low cost.

## **John Zamparo**

Dollars on the gross margin side, so I think the obsession with low cost production probably phases out over the next couple years and eventually we're probably not going to see as much of the product grown in Canada, I think this is similar to any other flower that eventually it's grown in a region that's more conducive to it. There's restrictions on importing and exporting and that might take five or ten years, but that's eventually I think where this industries going.

## **Mark Noble**

And the other big growth opportunity that we saw, I'm gonna change channels a little bit there, is the US side of things particularly on the CBD or industrial hemp side. What's your view on this because I think one of the big things that actually started to move the market forward post legalization was a movement towards some of the CBD providers that are listed on the CSC but also just a view that that in itself is an interesting growth market for both Canadian LPs and US companies that are listed in Canada. How big is that? Just that aspect of the business because it's getting a lot of media attention.

## **John Zamparo**

Mm-hmm (affirmative), and I think rightly so. The same way that medical legalization is the way to unlock recreational legalization, I think CBD is the entry way into THC and into cannabis in general and it's certainly popular, no one's doubting CBD's popularity, you can travel across the US and find it in drug stores and grocery stores, gas stations, coffee shops, all over the place, right? I mean it's seemingly ubiquitous, but depending on who you ask it's legal, it's illegal, that certainly wasn't clarified I think by the FDA.

## **John Zamparo**

So you mentioned the Farm Bill, that was supposed to be a massive event for the industry. I think it still was a critical step that did occur, but I think it was mid-December of 2018, everyone assumed that CBD would be 20x this year and would just be a huge growth industry, and I think it was the same day the FDA came out and kind of said to everyone, "Pump your breaks on that. I'm still in charge here and this can't be in the food supply because it's never been in the food supply, and this is used as an active pharmaceutical ingredient in a couple drugs we've looked at." So there's a lack of clarity from the FDA and I think that has to be fixed before the whole industry can really grow in a natural way.

## **John Zamparo**

But that said, several of the retailers who are large in the drug and grocery space have said, "We're willing to embrace this, especially in non-food items." You know, balms, and tinctures, those types of things. It's becoming more and more popular, so I think it'll get there. It's similar to all of the cannabis products we're talking about today, it just takes maybe a little bit longer than advocates would like, but it's certainly getting there and it's a challenge for the FDA, I can certainly understand that, not only to regulate but to enforce these laws. So I think that will determine the future of this, but there are so many people out there who say, "I don't care what the law is, this helps my nausea, or my inflammation, or my..."

## **John Zamparo**

Yeah exactly, there's all sorts of stuff and like I said earlier, I don't think it's going to cure cancer, but to some extent whether it's real or not, if it's just a placebo effect, as long as it makes people feel better. If it's not harmful to them, I don't think there's any reason for us to stop the sale of these products. So they might take another year or two, but I think the companies that have focused more on purely the CBD side have outperformed and probably will continue to do so in the near future just because they seemingly are less of a target of regulators.

## **Mark Noble**

And they get a pipeline to capital market's activity.

## **John Zamparo**

Yeah.

## **Mark Noble**

That actual cultivator of illegal marijuana which would be federally legal in the United States would not get.

## **John Zamparo**

And there's people out there who on an investing basis they look at ESG concerns and for some of them, those ESG concerns, environmentalism, social concerns, governance concerns, those are not triggered by CBD whereas THC will trigger those. And that's a whole different topic and

open to interpretation, but I think that's an advantage in and of itself is just the fact that investors are maybe a little bit more willing to look at it than some other names who are traditional MSOs.

**Mark Noble**

I mean do you look at the Canadian LPs such as Canopy who have put \$150 million in New York and they've talked about putting - it sounds like a CBD facility in almost every major state that allows for it. Where does that factor into your analysis? Like is that a good diversification plan for these companies?

**John Zamparo**

I think so, yeah. It depends on what it is they want to do and every company's unique. Some of them just simply do not want to be cultivators. They want to own brands, or they want to own a distribution aspect of it. They don't necessarily want to be vertically integrated. Canopy's made their plans known that they do wish to be vertically integrated, they want to own the cultivation assets, they want to own the retail brands and with three and a half billion dollars of net cash I probably would want to pony up and invest in all this too.

**John Zamparo**

Some other companies that are a bit more capital constrained are having to approach this industry in a more nuanced way and kind of having their horse out of the supply chain, but for someone like Canopy I think it fits in nicely but it's incumbent on each management team to figure out where it is they are most likely to succeed and Canopy certainly wants to be the biggest and the best and it wants to lead the way and I think it's led them to a great spot so far, for sure.

**Mark Noble**

So we've talked a lot about the good things, again, back to real business with real drivers of opportunity, but what keeps you up at night. I mean this isn't clear ceiling on a go-for-it basis. For those investors that are sort of looking to get into this base particularly now, what's the single biggest risk they need to be wary of.

**John Zamparo**

So you asked for one, I'll give you two.

**Mark Noble**

Okay.

**John Zamparo**

In order though. I think the biggest one is too many people look at this industry and say, "I know where cannabis is headed, I have full faith that this industry is going to proliferate and going to succeed," and I don't have any problem with that, I think that's fine. But even in an industry that does remarkably well, there are going to be a lot of losers in that industry. And we've seen this time and again throughout history, whether it's automobiles, aerospace, internet, you can keep going. There are industries that have done incredibly well, and companies that have fallen by the wayside and-

**Mark Noble**

I've got a nice palm pilot paper on my desk.

**John Zamparo**

Yeah exactly right. I mean you can think about all sorts of these, and even the companies that are incredibly successful can see their valuations tank. I mean we have such short memories, but I think Amazon got down to single digits on a per share basis when things got pretty rough and that's one of the most valuable companies in the world today. So you can be right in the very long term about companies or industries, but it might be very, very challenging in the medium term or short term to get some of these stock picks right.

**John Zamparo**

So picking an industry is very different from picking companies and for a lot of people, I don't think they know what they're necessarily getting in to. They hear about a name from a friend or a family member and they hear that it's in the cannabis industry and they think, "Well this can't go wrong," and they're buying it blindly and they don't really know what they're getting. And that's fine if you're playing with money to lose, but it's different if that's your retirement money. So I think information asymmetry in this business is far worse than in any other industry we follow. And there are a lot of very promotional people in this industry who maybe aren't going to execute as they would like. So I think that's probably the biggest risk but if I can get more wonkish than that, I think even among my colleagues and peers we maybe have too high expectations for this industry.

**John Zamparo**

And I think last I checked if you add up all of the sell side estimates for Canadian producers for sales in 2020 it's \$7 billion dollars.

**Mark Noble**

That's very aggressive.

**John Zamparo**

Yeah, it is. I mean I think our latest estimate for retail sales was under \$4 billion for 2020, and you think about producers only get about two thirds

of that, you can kind of do the math on \$7 billion dollars, people are going to be very disappointed with some of these companies. So I mean it all kind of folds under the same thing of you can have your view in the industry doing incredibly well, but pick the wrong name along the way and do very poorly. And I suppose that speaks to what you guys do here of course.

**Mark Noble**

Right, providing sector exposure.

**Mark Noble**

Listen, John, I think we can just keep going on and on on this, this has actually been fascinating. We're going to have to have you definitely come back, but I think for investors, I think what we try to provide here is a good understanding of there's a sector story here, and understanding what drives that sector, and looking at the research of what will drive these companies on a go forward basis, we've definitely hit some of those. We've talked about a lot of the bullish things that are out there including the global expansion and the fact that Canada's probably just inning number one or two of a nine inning ball game on a global basis.

**Mark Noble**

But there's a lot of risk here, this is a high-risk, high-reward space, so looking at diversification, looking at the entire sector are definitely key ways you're gonna wanna look at that. So I'm gonna leave it at that today, we will have 4/20 coming up shortly in the next little while, and this is our 4/20 edition of this podcast. But really wanted, again, think about this from an investment lens, there's a lot of noise in the industry and so hopefully today we've been able to do is really clarify if you're looking at this as an investor, where are those opportunities, and certainly they exist, but they come with some of the caveats we talked to.

**Mark Noble**

Thank again, thanks John, look forward to chatting in the future.

**John Zamparo**

Thank you Mark, appreciate it.



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