

Mark Noble

Hello, I'm Mark Noble, Executive Vice President of ETF Strategy at Horizons ETFs. Welcome to the latest episode of Generation ETFs. There's been a lot of excitement in the marijuana and psychedelics sector in 2021. The prospect of full-scale legalization in the U.S has brought a lot of the major marijuana cultivators on both sides of the border into a lot more focus for a lot more investors. Meanwhile, the therapeutic potential of the upstart psychedelic sector seems to also be winning numerous converts, again, in the retail sector. Sometimes in all of the excitement over the transformative potential of these two sectors, we can forget about the investment case as to why or why not the sectors maybe compelling investment opportunities.

Mark Noble

With us today is Andrew Partheniou, Associate VP of Institutional Research at Stifel GMP. We're excited to have Andrew on the program today because he's taken a real pioneering approach in the Canadian analyst community to cover a lot of the growth areas of the marijuana and psychedelics sector, which candidly, have largely been ignored by the broader institutional research community. Andrew was an early adopter of research in cannabis and later U.S. cannabis companies, referred to as multi-state operators and finally, of course, the psychedelic companies. Andrew will provide us today with his views on the sectors and the key opportunities and risks associated with these investments.

Mark Noble

Of course, at Horizons ETFs, we have a multitude of ETF strategies providing exposure to both cannabis through the Horizons Marijuana Life Sciences Index ETF (HMMJ), the Horizons U.S Marijuana Index ETF (HMUS), and most recently, the Horizons Psychedelic Stock Index ETF, which trades under the ticker symbol, PSYK. Andrew has no affiliation with us or these ETFs, so his opinions are purely related to these sectors and views. And we're really taking an educational approach here today to get a sense of what's going on in those sectors. Andrew, thanks so much for being with us today.

Andrew Partheniou

And thanks for having me.

Mark Noble

I think I really wanted to start by asking you about your foray into initiating coverage in these sectors. These are clearly new areas of research for the investment management industry. And I think our audience would like to know what drew you to coverage on this space?

Andrew Partheniou

So, I would say the story here starts really with the beginning of my career in investment management. I come from actually a technical background, having graduated with a bachelor's degree in engineering, spent a number of years there and then returned to school to do my MBA and there I found investment management. I was lucky enough to land an opportunity at GMP Securities, which is the firm that actually pioneered the cannabis space in the investment management industry. I was working with an analyst named Martin Landry who was covering Canopy Growth before it was called Canopy Growth at the time in 2014, it was called Tweed. So when I joined in 2017, I had a great opportunity to learn about the cannabis space, which at the time it was before Canada legalized cannabis in 2018. And it was really the perfect time, essentially a perfect storm actually, where cannabis companies in Canada were ramping up.

Andrew Partheniou

We had a great business at GMP Securities educating the investment industry with these opportunities and naturally it just grew from there going from Canada to the U.S. because as you well know, the opportunity in the U.S. has only grown from that stage as well. And we expanded our reach from Canada into the U.S. and brought a number of those companies public as well. And this all was brought into the fold when GMP Securities was acquired by Stifel Financial. And from there, I translated into being the lead cannabis analyst for Stifel GMP, which is now the trade name that we're called here up in Canada. And funny enough, the analyst Martin Landry, he was covering cannabis and consumer products, and now he focuses on the consumer sector and I focus on the cannabis sector with, as you mentioned, psychedelics having recently come into the foray.

Mark Noble

It's interesting too, because you're one of the first analysts to really start to look at the MSOs and that dovetails into my question because compared to 2018 and 2019, which were really tough for the cannabis sector, we've really seen valuations soar for Canadian LPs and U.S. MSOs alike. I'm assuming there's a number of factors here. We've talked about a blue wave in Congress potentially impacting things for legalization, but from your perspective, how much of this is priced in and would you expect this momentum to continue through 2021? Or do you think that a lot of the good news from potential legalization has already priced in?

Andrew Partheniou

So there's a lot to unpack there, right? I think the first thing that everybody needs to think about is, the cannabis industry is brand new, right? This is the beginning of a new industry that will be with us for a very, very long time. I think the last time that we've seen something similar to this happening is essentially prohibition back in the 1920s.

Mark Noble

Like Seagram's in Montreal, back in the 1920s.

Andrew Partheniou

Exactly, so this is a unique opportunity that investors have that they can get in on the ground floor of a brand new industry as it's being built. And of course, there will always be winners and losers, but it's an interesting thing to think about when you have an existing market that's been illegal for so long. And it's large, larger than anybody really knows because of the fact that it's illegal there's not any reliable data that we can point to. We can have our estimates and everything like that, but it's very difficult to really have an extreme amount of confidence onto the size of this legal market. And so as this is being deregulated and legalized, we're bringing that illegal market into the legal channel, which is where investors have the opportunity to access that type of growth.

Andrew Partheniou

And on top of it, you have an entire wave of new consumers that have never tried meaningfully, cannabis in any way. And so that could essentially compound on the existing market that we have ahead of us. Now, thinking and bringing this back into valuations and public cannabis stocks, we definitely have seen over the past three years, a high degree of volatility. I would say overall, the market is still quite inefficient and we're still in price discovery. And in my view, I think that there's still a ton of opportunity on both sides of the border, but on the U.S. side with the MSOs, there's a certain, what I like to call, regulatory arbitrage opportunity that retail investors especially can really take advantage of and it's something that's, again, a bit unique. So essentially what this means is that you have investors overall, especially institutions that have difficulty accessing these U.S. MSOs, they have difficulty investing in them because of the fact that it's federally illegal and compliance departments and there's essentially regulatory obstacles preventing them from fully accessing this opportunity. And what this means is that for retail investors that can access this, they'll be getting essentially growth stocks at value multiples.

Andrew Partheniou

And so to answer directly your question, no, I don't think that this is priced in. We had New York recently legalize cannabis and the stocks have not really moved that meaningfully, right? And New York could be a huge market going from a hundred million, 150 million right now to, estimates are out there, it depends on what the regulations are, but we could see anywhere between three and \$8 billion and perhaps a lot more. There's a ton of tourists, it's the financial capital of the U.S. and it's a huge part of the industry and yet shares have not really reacted meaningfully. So that's just one example and there are many others out there.

Mark Noble

Just taking a step back for one second there, I think even a lot of our listeners are probably aren't even aware of the difference between the MSOs and the LPs where the names are familiar with our course like the Canopy Growth and Aurora and the Tilray, Aphria, but those are Canadian LPs that have listed in the U.S. but the large multi-state operators are only listed in Canada. So it's counter-intuitive that you have these large Canadian companies that have seen a big uptick, but what you're referring to is the fact that the actual companies in the U.S. haven't seen an uptick because they can't really be purchased.

Andrew Partheniou

Yes, exactly. You have certain Canadian companies that have ingenious ways of trying to access and have some kind of exposure to the U.S. market. But in reality, the companies that have licenses and are generating revenues today from the U.S. THC market, they're not listed on the NASDAQ, they're not listed on the New York Stock Exchange, they're not listed on the TSX. They're listed on the CSE and the Neo Exchange. So from that type of perspective, it's a lot, there's more obstacles for investors to be able to access these companies and for those investors that can, it presents an amazing opportunity for long-term holding these investments for future growth.

Mark Noble

And just a quick follow-up on that, when you're doing analysis you're using primarily enterprise value to sales, is that the main metric you'd be using to look at that evaluation?

Andrew Partheniou

So we do look at enterprise value to sales. That is definitely one tool in our toolkit. I think it's incredibly important to look at EBITDA as well, especially for the U.S. companies, because it's a measure of their profitability. And the fact that they're able to generate that this type of growth that we're seeing and at the same time have these types of strong margins, is incredibly attractive in the entire market really. You have these companies that are generating the type of growth that are miles ahead of other public staples companies. And even if you take a look at and compare it versus tech companies, the U.S. MSOs screen relatively attractively. So E.V. to sales, enterprise value to sales is one metric, but enterprise value through EBITDA is also incredibly important I think.

Mark Noble

I find that it's just astounding the idea that you could have this new sector, which a large portion of it is basically trading at value investing metrics. So it's very counterintuitive. Just switching pace a little bit, in terms of when you're looking at the sector are you looking much beyond the U.S.? Is there a large amount of growth to be generated outside of the United States in your view, or is that primarily the focus of growth over the next little while?

Andrew Partheniou

Well, it depends what kind of companies you're looking at, right?

Mark Noble

Right.

Andrew Partheniou

If you're looking at a company that's on the smaller side, they could still generate some attractive returns for shareholders outside of the U.S., right? Canada, even though it might not be as an attractive market as the U.S, there's still a lot of opportunity to be had and investors can still make money investing in Canadian cannabis companies. And outside of that, cannabis is a global business, whether you're looking at THC or CBD, but the regulations are very different from one jurisdiction to another. You have Australia and Europe, there's companies out of Colombia that are trying to take their THC and CBD products and distribute on a global basis.

Andrew Partheniou

It's a different dynamic when you're talking about that side of the world versus Canada and the U.S. They're slightly behind in terms of development on regulations and deregulation when compared to Canada and the U.S. So it's an earlier opportunity, smaller, but still attractive. At the end of the day, you want to take a look at the company that you're looking at and what's the best return on capital and what's the best way for a company to deploy that capital in a way that it will generate accretion and returns for shareholders.

Mark Noble

So another recent phenomenon that you've taken a leadership role on is the entry of the psychedelic sector really gaining a lot of traction. Now, I understand in addition to the analysis on the cannabis sector, you also watch a lot of these emerging psychedelic names. Let's just start there, what similarities do you see here and what differences after that versus the cannabis industry when you started covering that? Because it seems like a lot of the excitement seems very familiar to me, it seems like a 2017 kind of excitement around the sector, but I'm curious to know what points of differentiation are there between those two sectors?

Andrew Partheniou

Yeah, so you bring up a good point. There are a lot of similarities and differences between the two sectors. The similarities I would say is, psychedelics is very much a nascent industry. This is really the beginning of a next wave of what I think is a potentially disrupting opportunity in the pharmaceutical sector first and foremost. So just to give a little bit of background, these psychedelic drugs, they were actually being studied in terms of a scientific way and a medical standpoint earlier on in our history before it was criminalized and put on onto the schedule in the war on drugs era. So before that, there are a number of studies that did point to benefits and these did not go through the entire pathway of the FDA because that takes a significant number of years and it's a lengthy process, but it was in that framework.

Andrew Partheniou

And so in the past, I would say 10 or 20 years, there's been a renaissance in these psychedelic drugs. And people are starting to look at them and think to themselves, "Well, maybe them being on the list of scheduled substances doesn't necessarily mean that they have no medical value, right?"

Mark Noble

Right.

Andrew Partheniou

And in a certain way, cannabis may have played a role in this type of renaissance. And so with cannabis having a similar wellness effect, which is still, not have gone through the entire FDA pathway outside of a few or a single example, psychedelics is very much in the same space right now. And what I would say is the main difference is where you're going to see or where we are seeing right now, actually, the value being created.

Andrew Partheniou

So in the psychedelic sector, there are a number of companies that have gone public in recent months and years. And by and large, they've been pharmaceutical-focused versus off-label or recreational-focused, which is where cannabis kind of lies. And so the psychedelic drugs, there are companies that are taking them through the clinical pathway. There are also non-profit companies that are taking a closer look at these with MAPS and Usona Institute being a couple of prominent ones. We're talking about phase one, phase two trials that are currently ongoing in a number of these drugs. And if the early indications are actually true, it could really disrupt legacy treatments, for example, with antidepressants treating depression. It could provide a much better way of treating patients and a much faster way of treating patients with quicker onset and quicker remission rates if the data that we're seeing, which is now preliminary, actually comes to fruit.

Mark Noble

But it does sound like it's a bit more of an all or nothing proposition, right? With marijuana, you have that recreational business, with these companies a lot is depending on FDA and drug approval.

Andrew Partheniou

So yeah, there are some companies that are exploring different ways of creating value, for example, opening up clinics or looking at nutraceuticals, a couple of examples. And by clinics, I mean psychotherapy clinics where they take existing and legal psychedelic drugs, for example, ketamine, to administer to treat certain indications. And so that's one way of creating value outside the pharmaceutical pathway, but for the clinical trials and the FDA pathway, it is a binary investment, they're either successful or they're not. And one thing that a lot of investors look at is what is the pipeline of drugs, for example, if you're looking at the company that is only doing clinical trials? Do they have all their eggs in one basket and are focusing all their efforts on only one drug? Or do they have multiple different drugs that they're looking at putting through clinical trials?

Mark Noble

I guess the primary drug that seems to have captured the imagination is the psilocybin, right? That seems to have the early mover in terms of FDA approval amongst some of these providers?

Andrew Partheniou

Yeah. So psilocybin is one of the drugs that are the most popular right now in terms of advancement through the clinical trial pathway. There is non-profit, the Usona Institute, for example, has clinical trials ongoing with psilocybin. COMPASS Pathways, listed in the U.S., is a prominent company and one of the largest in the industry, and they're currently in phase two trials with the psilocybin-based drug.

Mark Noble

Now, where does the revenue opportunity come in for these companies? Does it come, in your view, primarily from the IP related to pharmaceutical treatment?

Andrew Partheniou

So right now what we're seeing is the majority of value being created through drug development efforts. That's not to say that there's no value to be created in other ways that I mentioned, through operating physical clinics, or even sometimes a digital clinic, or through nutraceuticals, or even the production and selling of psychedelic drugs in the legal medical channel. So there's definitely more than one way to create value, but by and large, yes, what we're seeing is the most significant value right now is through drug development.

Mark Noble

And then my final question just on this sector, because we've clearly highlighted some of the macro themes if this could disrupt pharmaceuticals and antidepressants, but from an analyst perspective where's your key area of concern? Are there certain red flags or risk metrics that you're looking at when you're evaluating these companies?

Andrew Partheniou

Yeah. Look, there's not one investment out there that doesn't have risks associated to it. So when we look at psychedelic companies, you have to be cognizant of, in my opinion, the fact that it is a nascent industry, right? We haven't yet seen a hallucinogenic drug go through the clinical trial process. And on top of that, a lot of these drugs have extremely long hallucinogenic effects, while we're talking about this on the span of 48 hours or sometimes even longer. And so when you pair that with psychotherapy, it becomes a very difficult proposition where you need coaching essentially to make sense of the hallucinogenic experience that you have just had. And to make that hallucinogenic experience have a positive effect or positive outcome on the underlying mental health issue.

Andrew Partheniou

Now, that being said, there are companies out there that are trying to improve on the length of time of that hallucinogenic experience and they're essentially taking existing psychedelic compounds, modifying them chemically, or in a certain way to create a novel compound that has better IP protection and also has a better hallucinogenic profile that makes it easier to treat patients. So I think it's important to take into context what each company is actually doing. And what is the commercial opportunity for that, even though the addressable market could be large.

Mark Noble

Well, that's fantastic, Andrew and I can't thank you enough for joining us today. This is been illuminating for me, just hearing about the broader context of all these sectors. So I know it certainly will be from an education perspective for our listeners. And I really hope we can have you back in six months because this stuff is changing so quickly in terms of sector coverage. But again, thank you so much for your time today and I really look forward to connecting with you in the future.

Andrew Partheniou

Thanks for having me, I'm always happy to talk about it.

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by Mirae Asset

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