



Fall 2018

We are going to pot!

The legalization of marijuana in Canada has set off a buying frenzy for all sorts of cannabis related businesses. The interest in this sector has driven the valuation of emerging companies in this industry to speculative and unsustainable levels.

We are reminded of the 1998 to 2000 period. As many of you may recall, at the time any company related to the internet immediately and consistently went up in price. Public companies that had a “plan” to launch an internet related business were valued in the billions of dollars. Reality was suspended and all sorts of reasons and valuation metrics were developed to justify these extreme valuations. My all-time favourite valuation tool is the “market cap to eyeballs.” Anyone that didn’t understand this “new paradigm” was considered out of touch. Traditional businesses were at best ignored and in many cases sold at any price.

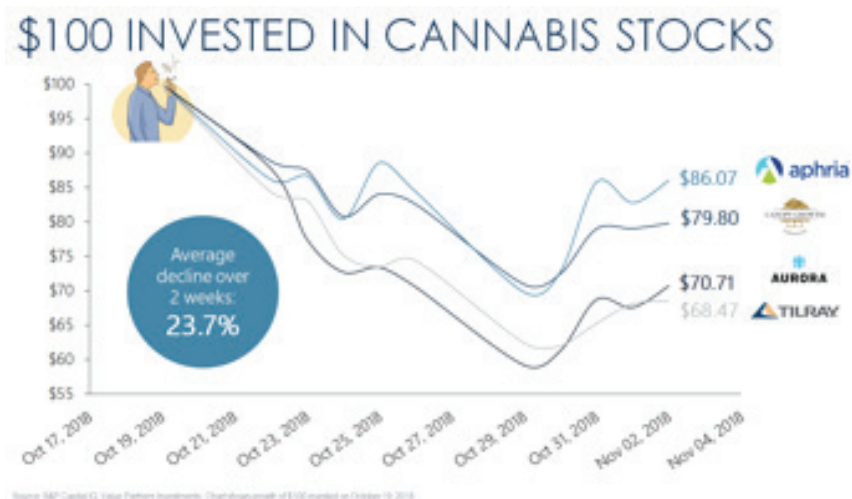
The sentiment is very similar today in Canada for cannabis investments. Below is the aggregate market capitalization of the top cannabis stocks in Canada. Collectively, they have a market value of forty-six billion dollars. However, these five emerging companies have less than two hundred million dollars in revenues, twenty million dollars in net income and do not pay any dividends. These translate into Price/Earnings and Price/Sales ratios of 2300x and 242x respectively. Dot.com bubble like valuations and extraordinary by any measure!

		
\$0.19 billion	REVENUE	\$16.8 billion
\$0.02 billion	NET INCOME	\$5.2 billion
\$0	DIVIDEND	\$1.9 billion
\$46 billion	MARKET CAP	\$50 billion

Source: Public Capital Management, Report in [CBC](#), Nov. 11, 2018

In contrast, the Canadian Imperial Bank of Commerce (CM) generates billions of dollars in revenues, net income and dividends for only a slightly higher market cap. Just as importantly, CM has a long history of operations, a well-established business model and many years of financial information that can be analyzed.

While returns have been spectacular over the past few years, profits can literally go up in smoke very quickly. As the graph below illustrates, (created by the team at Value Partners) these five cannabis stocks lost close to twenty-five per cent of their value in just two weeks.



Just as in the dotcom bubble scenario, substantial losses will occur as reality sets in and the realization that expectations built into cannabis stock prices are unsustainable over any reasonable investment time horizon. It is quite probable that ninety per cent of investors in this sector will lose ninety per cent of their money.

More worrisome are the expectations that these speculative bubbles set, and the resulting impact on investor behaviour. The headlines generated by these speculative returns, dinner party chatter and friendly tips, all give rise to the impression that market returns have been quite strong. When most people look at their holdings and returns, they are disappointed at having missed out on these supposed gains.

In response to this misperception many investors move their assets and/or sell out of long term sound businesses to buy speculative investments in the hope of earning large returns. This behaviour usually occurs at the very wrong time and results in the permanent loss of capital.

The reality is that market returns in Canada have been very low over the last several years. As of October 31st, 2018 the TSX/S&P Total Return Index posted a negative return over the past year and year to date. As well, global equity markets, with the exception of the United States, have also posted losses over the same time periods. The S&P 500 return has been positively impacted by the strong performance of the FANG stocks. Without the speculative returns from this small group of high tech companies, the U.S. market would have suffered losses as well.

In Europe, Germany's DAX and Britain's FTSE 100 have been in negative territory for most of the year and are down seventeen per cent and twelve per cent respectively from their recent highs. China's major market index is now down twenty-eight per cent for the year. Canada's S&P/TSX Composite Index has fared no better. It is down ten per cent since July and down five per cent for the year.

Below are the returns of global indices for the periods ended as of October 31st, 2018:

	One Year	Year to Date
S&P/TSX Composite	-3.41 %	-5.00 %
World Index Ex US	-6.28	-8.89
Europe	-7.76	-9.37
Japan	-3.24	-6.72
Pacific Ex Japan	-6.07	-11.02
S&P 500 U.S.	7.35	3.01

The reasons for the disappointing returns are:

- Mounting global trade barriers and tension;
- Slowing global economies; particularly in China;
- Rising interest rates;
- Increasing global deficits;
- Growing political uncertainty;

In addition to the above concerns Canada has its own set of problems. The current Canadian government's policies are perceived to be "anti-business". Regulatory costs and barriers and corporate taxes are high; particularly when compared to the United States. In addition, the federal government is incurring large budget deficits. Foreign observers are also concerned about our real estate markets and historically high personal debt levels.

Foreign investors have taken notice and are withdrawing their capital from our markets. This flight of capital is most evident in our energy sector. The Federal and Alberta governments have made it very costly for the energy sector in Alberta. Regulatory requirements, carbon taxes and environmental delays make our resource sector less competitive. To compound the problem, Canadian energy companies are incurring steep price discounts on their oil due to the lack of market access as pipelines get delayed.

¹ Returns are in U.S. dollars except S&P/TSX Composite in Canadian Dollars

This unfavourable environment has taken a toll on Canadian equity markets. Over the past two and four year periods the TSX has returned a paltry 3.8%. Our returns have been disappointing as well over these time frames; particularly as the energy businesses that we have invested in have suffered from the unfavourable environment discussed above. Our results have also been impacted by the low level of interest that we have earned on our T-Bills.

However, we are optimistic for future returns. Our investee companies are performing extremely well. They continue to execute on their strategies, improve their competitive position, slash debts, improve their balance sheets and return capital to shareholders through increased dividends and/or share buybacks.

This is particularly true of our energy companies. We are confident in their underlying value and believe that ultimately government policies will change to reflect the North American competitive environment. Although it has taken longer than expected to realize profits on these investments we do believe that we will earn positive rates of return on the energy businesses that we have purchased.

The recent down draft has allowed us to purchase very high quality businesses that offer the potential for substantial returns. Just as importantly, these new investments pay dividends that are above current interest rates. As a result, our portfolio income will increase. We are hopeful that the current downturn will provide us with more opportunities to make attractive investments.

At PCM we are unabashed value investors. A long view of history, finance theory and common sense suggests that buying shares of sound businesses below intrinsic value should eventually provide positive returns. But sometimes it can be a long wait.

A longer than usual wait breeds doubt. Surging share prices of companies in growth industries and new technologies often render traditional value investing irrelevant. Similar attitudes emerged during the late nineties

dotcom bubble, only for the value approach to be vindicated. The reality is that value investing is a contrarian approach. That means it fares badly for periods of time. Patience and doubt is the price value investors pay. The reward is above average long term returns with substantially less risk.

Our true reward comes from serving you.

All of us at Patient Capital thank you for the privilege.

Vito Maida



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