LEVEL5
STRATEGY GROUP

SERIES:

OUR PERSPECTIVE
ON CANADA'S
GROWING CANNABIS
INDUSTRY

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CROSSING THE INFLECTION POINT

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Crossing the Inflection Point

The Dramatic Shift in Competitive Realities Facing the Cannabis Industry

Over the last 17 years, in many regulated industries, LEVEL5 has been fortunate to work with hundreds of clients helping each of them build and keep a unique and ownable go-to-market promise that allows them to grow market share, create loyalty and increase profits. Across industries, from retail to beer, from packaged goods to gaming, we have worked with our clients to plan and execute against distinct challenges and opportunities. Some of the most challenging issues involve government and regulatory considerations – where public interests and commercial ones collide.

We have seen many business inflection points over the years, but October 17, 2018 marked the dawn of a particularly exciting yet complex one. In the months prior to legalization and in the months since the industry has experienced highs and lows. Nowhere is this more evident than in the stock price swings in the sector. Investors are reacting to an ongoing flow of news whether it be the latest joint venture, an emerging scandal, new proposed regulations, a changing retail framework, and so on. Companies are on the hunt for acquisitions or on the lookout for their suitors. This wildness is not new. It is what emerging industries experience.

Without question, the next 12 to 36 months will be the most intensely competitive and dynamic time for the industry. Before the dust settles, clear winners and losers will be identified. This is simply what happens as industries begin to mature. The question for those associated with the industry is this: How can you better prepare your organization to ensure you remain on the right side of that equation?

Winners know how to navigate this challenge. Historically, they have done so through a well-developed brand and well-developed business system.

In this perspective piece we will lay out our initial take on the Cannabis sector. In the coming weeks, following pieces will cover a range of topics that are critical for organizations looking to land on the winning side of this exciting industry. These include: building a brand in this tightly regulated sector, developing a strong customer experience across owned and influenced touch points, and overcoming the challenges of current cannabis perceptions and stigmas.

We hope you enjoy this first perspective piece in our series on the Cannabis sector.

The dawn of a new age

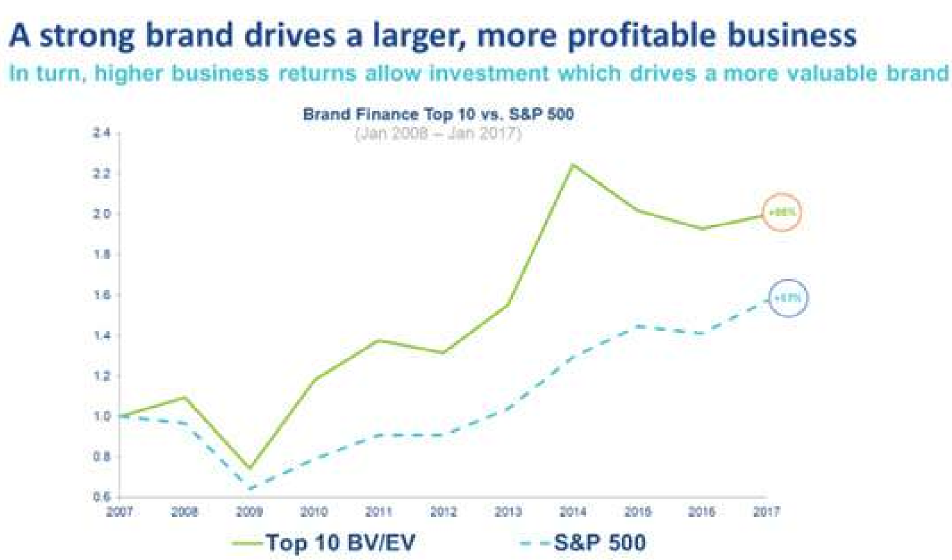
It is rare that one can pinpoint the exact date on which a new industry is born, but that is precisely what Canadians can do with October 17, 2018. It was on this date that Canada legalized recreational cannabis use, bringing a black market with an estimated value of $5.7B[1] out from the cold and (at least to some degree) into the safe, governed, and regulated confines of a full-blown, tax-generating, national industry.

As we in the Canadian business world witnessed, the lead up to October 17 created a race to licensed producer (LP) status. Companies were formed, business plans created (and re-created as regulations were clarified), operating strategies were built, talent was hired, and market share strategies were initiated. October 17 literally begat the dawn of the recreational cannabis sector in Canada. However, with every sunrise inevitably comes a sunset, and that is when those who fail to prepare find themselves left in the dark.

Predictably, the months immediately following October 17 represented a period of rapid and dynamic growth for those involved in the production, manufacturing, and distribution of cannabis. It seems that everyone, from growers to investors, has been chasing the notion of "more," "bigger," and "broader." In other words, scale, and the race for it, has shaped the primary competitive battlefield these early days. However, many of today's players are still nascent, with little revenue and unproven operations.

As the sector begins to mature and investors begin to look for returns, there will be a predictable change in attitude. The focus will turn towards enterprise strategy, operations, and go-to-market execution. Consolidation will emerge and winners and losers will become evident. We will see a shift from the short-term focus on "grow at all costs" to a longer-term perspective – one that stresses the development of a sustainable brand and business system with the strength to survive and thrive in the long-run. After all, businesses across sectors with strong brands endure and are valued significantly higher than those whose brands are weaker.

This is not a novel prediction. One need only look to recent history and current industry dynamics to see the proverbial writing on the wall.



A shift is upon us

Excess capacity combined with limited export opportunities will, in short order, place a greater emphasis on revenue growth, supply agreements, partnerships, and IP ownership.

The first hints of the shift in market maturity are already evident. M&A activity nearly doubled in the first half of 2018 from a year earlier, with 145 deals happening in the cannabis industry in North America.[2] Much of this activity took place in the Canadian market as major players sought to rapidly increase their capacity and improve their strategic positioning in anticipation of legalization.

Large established players have already started moving into the market, raising the stakes, expectations, and professionalism of the entire category. Constellation Brands, for example, acquired a 38% ownership stake in Canopy Growth Corp; Molson Coors entered into a joint partnership with The Hydropothecary to develop cannabis-infused beverages; and Altria acquired 45% of Cronos Group for $1.8B. These moves are early signs of a landscape that is shifting towards a more disciplined and mature state.

In the coming months, the market's obsession with capacity will compound the challenges for players that have not started to move towards building a brand and sustainable business. The capacity of Canada's top 10 licensed producers alone is projected to be double the country's demand by 2020.[3] Soon, playing only the capacity game – without the partnerships and contracts to protect supply and demand – will no longer be enough to woo investors and please the market.

While Canada may be a leader on the global stage, the export market isn't a silver bullet for sustaining growth, and this adds a new level of complexity to the cannabis industry. In the U.S., cannabis (outside of the Farm Act) is still illegal at a federal level meaning it is essentially a no-go for Canadian excess capacity. International markets outside North America are quickly establishing domestic production to meet local demand for medical-use cannabis. In fact, companies wishing to participate in international markets for the long-term are building even more capacity for production in regions across Europe, South America, and beyond. This includes Canadian licensed producers such as Canopy Growth Corporation, Aurora, Tilray, and The Cronos Group.[4,5,6,7]

Excess capacity combined with limited export opportunities will, in short order, place a greater emphasis on revenue growth, supply agreements, partnerships, and IP ownership. Consolidation for strategic purposes is a likely end game.

We have already seen the beginnings of consolidation in the U.S. High Hampton Holdings, a company with the stated intent of "Consolidating California", has acquired major edibles manufacturer California Gold Inc. as well as leading extract producer Mojave Jane.[8] Origin House, aiming to become the first global brand house in the cannabis industry, recently acquired California-based craft producer Cub City[9] and increased its ownership stake in leading Florida and Arizona medical producer AltMed.[10]

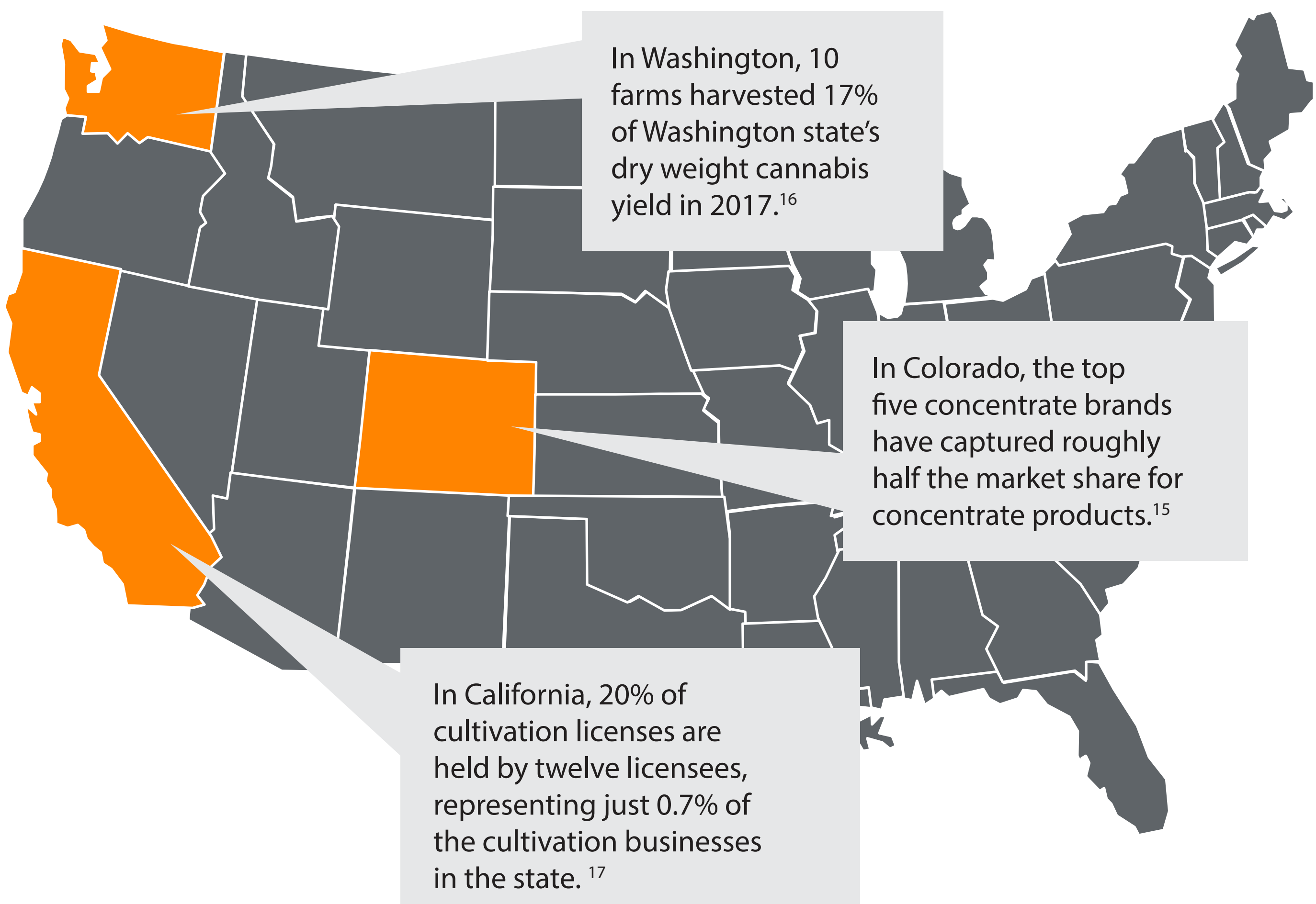
We've seen this before

This type of turbulent and financially speculative business environment was seen during the dot-com bubble and, more recently and relevantly, in those U.S. states in which adult-use cannabis has been legalized.

The dot-com scenario of the late '90s and early 2000s was rampant with big ideas followed by big investments and big opportunity. However, as quickly became evident, high hopes and sustainable success do not go hand in hand. Roughly 50% of dot-com companies survived those early days, often due to companies simply running out of cash.[11] When the bubble burst, many companies were losing between $10 million to $30 million a quarter.[12] For a cautionary tale, look no further than Pets.com, which went from an $83M IPO and peak market cap of over $300M to liquidation in less than 300 days.[13] The company literally launched, grew, and liquidated within a two-year span.[14]

We raise this comparison not to draw a literal parallel (after all, the dot-com era spawned a new technology and cannabis has been around for millennia) but to outline how enthusiasm around new industries eventually peters out while a focus on strong business strategy and consistent execution endures.

This rise and fall pattern has also been playing out in U.S. state-based recreational cannabis markets, where obvious winners and losers are emerging:



So, what's next?

> *At LEVEL5 we define a brand as **The Value of a Promise Consistently Kept™.** For players in the cannabis industry, driving value and ending up on the right side of history will entail making an exceptionally clear promise to customers and partners.*

Navigating the choppy waters ahead will require the development of a strong brand, the systems to uphold that brand through execution and a clear plan for differentiating and growing consumer loyalty in a complex and vertically segregated retail environment. Important factors to consider when creating such a plan include establishing and communicating your value proposition; strategically managing your value chain, establishing the partnerships and supply agreements required to protect revenues; establishing the IP, competencies, and core processes to avoid commoditization; and continuously keeping an eye to international markets for opportunities to establish first-mover advantage in friendly regulatory environments.

But above all, building a sustainable branded business system in a historically commoditized environment requires purposeful differentiation from the pack, founded on a deep understanding and focus on the customer.

At LEVEL5 we define a brand as The Value of a Promise Consistently Kept™. For players in the cannabis industry, driving value and ending up on the right side of history will entail making an exceptionally clear promise to customers and partners. This promise must be the guiding light that informs every product, channel, partnership, and IP decision that the company makes on its journey towards becoming a sustainable branded business. It is the clarity and relevance of this promise that will help distinguish one business from its competitors as a potential partner; help an employee at retail recommend and communicate the uniqueness of a product brand; and help customers understand and differentiate one product from another and ultimately create an emotional connection.

Once this promise has been defined, players will need to organize their people, processes, and technology around it in order to ensure it is actually delivered, for it is consistently keeping a powerful promise that ultimately separates strong business ideas from strong businesses.

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Authors

Efram Lebovits is a Principal with LEVEL5 Strategy Group and has worked in a variety of industries including retail, lottery, healthcare, and the public sector amongst others. He works closely with clients to develop enterprise and brand strategies as well as supporting them through transformation initiatives. Efram holds an MBA from the University of Michigan and a BBA from York University.

Sean Pavlidis is a Director with LEVEL5 Strategy Group, focused on building enterprise, brand, and customer experience strategies for a diverse range of clients. His work spans across a number of industries, with specific expertise in the retail and beverage alcohol space. Sean holds a BComm from Queen's University.

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For more information, please contact:

Efram Lebovits at elebovits@level5strategy.com or, Sean Pavlidis at spavlidis@level5strategy.com.

LEVEL5
STRATEGY GROUP

18 KING STREET EAST
MEZZANINE LEVEL
TORONTO, ONTARIO
M5C 1C4

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LEVEL5STRATEGY.COM

info@level5strategy.com

416 361 3468

www.linkedin.com/company/level5-strategy-group