Sharing the spoils of legalized cannabis

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Statistics Canada estimates that, in 2017, "*4.9 million Canadians aged 15 to 64 spent an estimated $5.7 billion on cannabis for medical (10% of the market) and non-medical (90% of the market) purposes. This was equivalent to around $1,200 per cannabis consumer.*" Private companies, several of them listed on the stock exchange and already supplying cannabis for therapeutic purposes, are preparing to service this soon-to-be legal market.

The federal initiative to legalize the production and consumption of cannabis has created more wealth in a few short months than what the organized crime could achieve from the illicit sale of cannabis in the same period of time.

For example, five of the six production companies that recently signed supply contracts with the Société des alcools du Québec (SAQ) are listed on the stock exchange (***Aurora Cannabis, Canopy Growth, Medreleaf, Aphria, Hydropothecary***). On February 16, 2018, the collective stock market valuation of these five companies had reached **some $15 billion**, whereas, in 2015, before any likelihood of cannabis being legalized for recreational purposes, their share prices stagnated and their collective market valuation did not exceed $500 million. Thus, as of February 15, the executives and board members of these five companies held shares worth an aggregate value of $910 million, as well as stock options worth more than $180 million.

Of course, the federal government argues that it is only replacing illicit consumption with licit consumption, with more control of quality and consumption and the elimination of criminal organizations. *The road to hell is paved with good intentions.* This fragile theory assumes that the product's availability at numerous sales points, the legality of consumption, the safety of the product and its competitive prices (to the price of illegal cannabis) will not generate a substantial growth in demand, i.e. that the number of consumers (some 4.9 million Canadians aged 15 to 64 in 2017) will not increase and consumption per user will remain constant.

The strategic and financial dynamics of this new market

Market dynamics and the logic of financial markets will determine the strategies and behavior of the producers. Companies, particularly those with boosted market value, will have to convince

investors/shareholders/speculators that future profits and profit margins will grow rapidly and that the global Canadian market may well experience substantial growth. The logic of financial markets is simple: continuously increase earnings per share or face stagnation or decline of the stock price.

The stakes are high for the management and directors of some of these prospective producers of "recreational" cannabis. They have gained large, fragile, paper wealth, which comes with great expectations. To meet the expectations and support continuous increases in the price of their shares, they must:

1) Quickly raise barriers to entry into the market in order to limit the number of serious suppliers; thus, already some producers are making large financial commitments to increase their production capacity as well as carrying out mergers and acquisitions to consolidate the industry. The goal here is for a small group of producers to quickly achieve a production capacity equal to or greater than the anticipated demand over the next few years. Volume, as usual, will have a powerful downward effect on their operating costs. Then, any potential new entrant will face formidable obstacles to raising the necessary capital as well as the prospect of major losses as long as its costs do not achieve the same levels as the incumbent firms.
2) Negotiate long-term contracts at fixed prices with the distribution networks to lock down the market for new entrants; set the prices based on current costs plus a reasonable margin; since these costs will fall quickly as their production volume increases, these producers will post growing profit margins, to the great satisfaction of the financial markets.
3) Through whatever means possible, taking into account the constraints imposed on them, promote highly differentiated product lines and create brands of products targeting distinct segments of the market.
4) Mobilize all the industry's collective resources to influence the political and administrative decisions that will determine the industry's future profitability.

This market will therefore consist eventually and rather quickly of an oligopoly of producers and, by law, regional distribution monopolies (at least in Quebec, Ontario and Alberta). This situation, a rather unique one, will generate difficult challenges for the State-owned corporations that are mandated to act as the purchasers and distributors of these cannabis products.

Setting the price for producers

Should a distributor in a monopoly situation set a purchase price equal to the producers' operating costs to which an acceptable return on their investments would be added, as would be done for a regulated industry? Should a price be negotiated which corresponds to the producers'

achievable costs, taking into account the impact on their costs of the very purchases contracted for by the distributor? Should long-term supply agreements be signed *only if the prices are indexed to the operating costs?* Should Ontario and Quebec create a buying group in order to negotiate best possible costs? Should the distributors require that its suppliers disclose the identities of their financial backers (in the case of an exchange-listed company, any shareholder holding more than 10% of the votes must register as such with the securities regulators).

The market valuation of the cannabis producers largely depends on the answers to these questions. An affirmative answer to all of them would cause their market value to tumble. The producers will obviously try to play purchasers in different provinces off each other and obtain long-term purchase commitments at a fixed price; they may also reach tacit and legal agreements with each other to set the base prices; and they will try to differentiate their products to create specific demand by consumers, thereby putting pressure on the distributors.

Setting the price for consumers

Important stakes are involved in setting the price of cannabis sold to consumers. In addition to taxes, what profit margins should the monopolist distributors tack on their puchase costs?

If the retail price is higher than the sale price of illegal suppliers, then they will continue to control a significant share of the market. [Statistics Canada estimates that some 19% of consumption comes from 15-to-17 year old consumers. That is, almost one fifth of consumers will be excluded from the legal market and may thus continue as clients of criminal organizations!]

If the retail price is set low enough to eliminate the illegal market, there is a risk this pricing policy will increase the demand in the legal market by attracting new consumers or by increasing the level of consumption.

Clearly, producers will want the profit margins set by the distribution networks to be low so as to generate the highest possible demand. Pressure on distributors and lobbying of government will be intense.

Conclusion

The legalization of cannabis consumption for "recreational" purposes creates a new industry and a new market. The stock market has reacted enthusiastically to the alluring nature of this new market, creating immense paper wealth and giving the companies in this industry a stock market value that will be difficult to sustain. The interests of shareholders, speculators and executives of these companies are not naturally aligned with the public interest. The State-owned corporations responsible for the distribution of cannabis will be at the center of the conflict between the interests of the various parties and will have to deal with sustained and subtle pressure to subject

them to the implacable logic of the financial markets. They will largely determine who benefits financially from this new market: investors, speculators, management or the Canadian tax payers.