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How high is too high for Australia's cannabis stocks?

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Perhaps it shouldn't be surprising that wacky things keep happening in Australia's nascent legal cannabis industry.

Take for example ASX-listed biotech Stemcell United's share price. Last month it skyrocketed 3800 per cent – from just over 1.3¢ to 41¢ – in less than two days.

It wasn't a groundbreaking scientific discovery in the field of medicinal marijuana that turned the Singapore-based biotech from a \$5 million company to one with a \$145 million market capitalisation virtually overnight. Indeed, the company hasn't even entered the field.

The astonishing price run was sparked by the appointment of a new "strategic adviser" to help the company "assess opportunities" in the sector: Nevil Schoenmakers.

This is the excitable global environment for investment in cannabis spurred on by both changes in some American state allowing for recreational consumption and reforms in Australia allowing its use for medicinal purposes.

Suddenly everyone wants a slice of an industry that is already worth billions.

The reaction to Schoenmakers' appointment is thanks to the Australian/Dutch dual national's legendary cannabis breeding reputation – fans lauded him as "The King of Cannabis" and the United States try to extradite him from Australia in the early 1990s. Arrested in Perth, he posted bail and then disappeared.

The founder of Australia's first listed medical cannabis company, Ross Smith, is only a few shades less colourful.



Illustration: Simon Bosch Photo: GOS

He floated Phytotech (now MMJ Phytotech) on the ASX in January 2015 to a roaring response – climbing from 20¢ on issue to 92¢ on their second day – only to resign as executive director two weeks later over a threatening social media rant. Smith said his Facebook account had been hacked.

Investors attracted

But despite these antics the industry has been too attractive to resist for some investors.



AusCann managing director Elaine Darby says there is an incredible amount of hype in the cannabis industry. Photo: supplied

To give a sense of scale consider that medical marijuana sales hit \$US4.9 billion (\$6.5 billion) in the United States last year and will reach \$US7.3 billion in 2020, according to research by marijuana investment group Archview.

The local industry is a fraction of that size but investors have still thrown money at Australian players since the growing of cannabis for medicinal use and research was legalised in February 2016.

“America is the Wild, Wild West: there are no standard set of rules that apply.”

BuddingTech Adam Miller

"We get phone calls all the time from people wanting to invest in the industry," says Merchant Funds managing director Andrew Chapman, whose small-stock fund has about \$10 million invested across four local medical cannabis companies.

"The reasons why the shares have done so well over the last six to 12 months is there's a lot of money chasing the theme, but there's just not many homes for the money to go into."



Perth-based medicinal marijuana company Phytotech Medical is on the rise. Photo: Gary Malerba

A handful of the Australian companies seeking to cultivate or manufacture medical marijuana in Australia are listed on the ASX, and nearly all have outperformed the wider market by a considerable margin this year.

Shares of three of the largest cannabis pure plays – AusCann, Zelda Therapeutics and MMJ Phytotech – each grew by more than 150 per cent in the past six months. The All Ordinaries Index on the ASX has lifted 12 per cent.



A government facility for growing medical marijuana in Israel. Photo: Getty Images

Sales question

The local industry shouldn't expect runaway sales growth like that seen in the United States, where individual states have legalised use of the drug, says Adam Miller, founder of medical cannabis technology and innovation accelerator BuddingTech.

"America is the Wild, Wild west: there are no standard set of rules that apply," he says.



World-renowned cannabis breeder Nevil Schoenmakers. Photo: Supplied

"They have a significant medical market but none of the products that are being sold there have gone under any clinical trials, there's no standardisation."

Miller says that while it is delivering eye-watering sales figures at the moment, most of the US industry would be shut down overnight if the federal government there put an industry framework in place that abides by the United Nations Single Convention on Narcotic Drugs.



Preparing Cannabis oil for medical use. Photo: Rohan Thomson

Australia on the other hand has gone by the book, he says, which means the market will grow slower but it will be compatible with a global market should it eventuate.

In California marijuana can be prescribed for a variety of conditions, including headaches or anxiety, and bought in a variety of forms. But Australian doctors can only prescribe the drug in pill or oil form and when there is scientific evidence that a certain product is effective for that condition. It is worth noting also that depending on the use the plants can be bred to virtually remove any intoxicating effects.

State and federal governments and the Therapeutic Goods Administration are still deciding what medical conditions qualify, but medicinal marijuana has been used to treat people who have epilepsy, chronic pain, chemotherapy-induced nausea and HIV/AIDS.

Companies that want to grow, import or manufacture cannabis oils or tablets need to apply for a licence from the Office of Drug Control, which has so far issued four licences for growing, two for research and one for manufacturing.



Health Minister Greg Hunt. Photo: Justin McManus

Market potential

Despite these constraints, Miller says there is a significant market waiting to be tapped. A white paper BuddingTech wrote with the University of Sydney found there would be a patient portfolio of about 30,000 Australians with epilepsy, HIV and multiple sclerosis that would seek to use the drugs. Those alone would be worth \$150 million to \$200 million a year.

No producer has brought an Australian grown or manufactured cannabis product to the market yet, with a Victorian government trial the only cultivation for medicinal purposes currently under way, according to the Department of Health. Patients are instead taking imported products.

Meanwhile hopeful participants like AusCann, one of the largest cannabis companies on the ASX, are still waiting for their licences to be approved.

"Everyone can see the potential but we still have this uncertainty," says AusCann managing director Elaine Darby.

AusCann has just harvested its first crop from its growing facilities in Chile. The majority will be used in clinical studies which, if successful, will mean AusCann can register those products and sell them there in about 12 months time.



Phytotech medical founder Ross Smith resigned as executive director following a social media furore.

Regulatory hurdles

With the opening up of the local market Darby says the company plans to be growing about two hectares of cannabis in Australia by the middle of next year. It will then need to take its produce to trial to prove it is an effective treatment for specific conditions before doctors can prescribe it.

In the meantime AusCann will start importing produce from Canadian company Canopy Growth, which is the largest manufacturer in North America and also AusCann's largest shareholder, with a 10 per cent stake.

Federal Health Minister Greg Hunt's move to relax importation laws in February sent AusCann stocks up 24 per cent.

While jumping through regulatory hoops is slowing the process, Darby says the biggest challenge facing the industry is convincing doctors to prescribe cannabis medication.

Because medical cannabis is not approved by the Therapeutic Goods Administration, doctors need to become an "authorised prescriber" of cannabis, while also complying with a layer of state-based rules – a process Darby says is onerous.

"The market potential is massive: if you look at chronic pain alone, that's conservatively a \$5 billion market sitting there," she says.

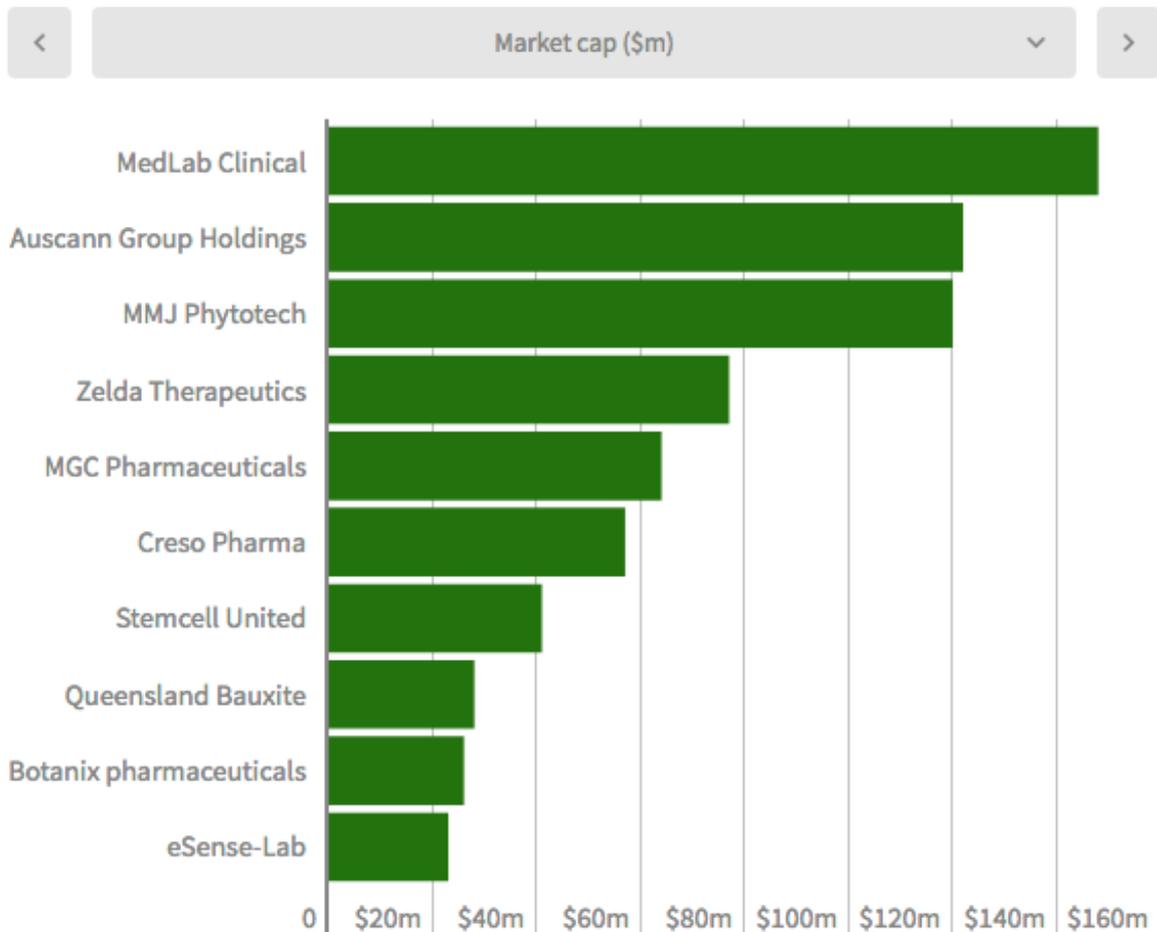
"But at the end of the day you need to get the doctors to prescribe. If you look at Canada there were only a handful of doctors prescribing, there's now in excess of 300 prescribing and well in excess of 100,000 patients and that's all happened in a couple of years. But if you look at their initial growth, it was very slow."

Manufacturing potential

MGC Pharmaceuticals has also been preparing for legalisation in Australia, and has set up trial operations in Slovenia while tapping expertise from Europe and Israel in anticipation of the local market opening up.

Flying high

Listed cannabis stocks have performed strongly



Source: Company statements and Bloomberg

"My view was that this industry was going to happen, it was just a question of if it was going to be one year or 10," says executive chairman Brett Mitchell.

Earlier in April it successfully started extracting cannabinoid resins from plants at its facilities in Slovenia and is taking part in a clinical study to discover if the drug can reduce the number of seizures experienced by children with epilepsy.

With legalisation, MGC is bringing its expertise in breeding, extraction methods and manufacturing of the end products to Australia, with joint ventures with a major east coast university and a hospital close to being inked.

Mitchell says it will have a set-up in Australia similar to that in Slovenia within a year. But as anything produced will need to go through clinical trials, Mitchell says he can't make revenue projections.

The uncertainty around when these companies will start generating meaningful revenue from medicinal cannabis has not dampened investors' enthusiasm.

Wariness wise

But Zach Riaz, director at the Banyan Tree Investment Group, recently compiled a report on the state of the local industry and warned that while it will be a significant and profitable

industry in years to come, some share price growth of ASX cannabis companies is getting ahead of fundamentals.

"I think investors need to be a bit wary," he says.

"These guys are in their early stages ... there's a lot of studies and trials that need to be conducted successfully before any of this can be commercialised and sold."

That expensive process could require capital raising, he says, a further risk to investors, while just one or two unfavourable results in the scientific trial could cause a company's share price to be "absolutely smashed".

"What their best chance is, and I'm pretty sure most of these guys are hoping for, is a big pharma company coming in to take them out."

Chris Macdonald, principal and investment adviser at Morgans Chatswood, notes that most of the stocks have fallen off from highs in March and had arrived at a "happy medium". "The government awarding licences a couple of months ago is what really set off the current hype, and like all of these bubbles they do run out of steam," says Macdonald, who has advised companies in the industry.

"People are still paying quite high multiples for these stocks that are pre-revenue, or certainly a number of years away from profitability because they're happy to bet on the fact that over the next three to five years they could potentially have access to very, very large revenues."

'Out of control'

Chapman says Stemcell United's "out of control" share price fluctuations (it has since returned to 11¢) risked damaging the reputation of the whole industry.

"Unfortunately, mum and dad investors get hurt in that," he says.

"We shouldn't be seeing that sort of stuff any more and I'm hopeful that we don't because it takes a bit of that credibility off the actual industry."

Chapman says his fund was one of the first backers of the industry, investing in Phytotech, the first to list on the ASX.

While Phytotech had a volatile start to life, jumping in value more than fourfold to 92¢ in its first two days trading and plunging back to 28¢ when its founder Smith quit following the social media scandal, it was now trading at 62¢.

"So it wasn't a flash in the pan," says Chapman.

"And now as the industry is maturing, and as the investors within the industry are maturing as well and understanding what goes into making a successful medicinal cannabis company, we should see less and less of that sort of behaviour."

Even Darby, from AusCann, says investors need to take a cautious approach when there was so much "hype" around the industry.

"I don't know how well thought over or considered it is by investors at the moment," she says, adding that AusCann has be careful to outline realistic potential growth for the company.

"Unfortunately the nature of this particular industry, just because of what it is, attracts some very interesting individuals. And then you've got some on the other side that are just after a buck at the end of the day: they're going to sprout any kind of idea and let it do a run. There is just an incredible amount of hype, for sure."