



Nurturing new growth

Canada gets ready for Cannabis 2.0



Table of contents

Introduction	1
Cannabis 2.0: Canadian survey insights	4
Perspectives on Cannabis 2.0	22
The way forward: Thriving in a Cannabis 2.0 world	30
Remain bold	32

Introduction

All eyes remain on Canada as it prepares for the next stage of cannabis legalization—a step that will keep the country firmly at the vanguard of a societal revolution and a new industry explosive with potential. “Cannabis 2.0” will see edibles containing cannabis and cannabis concentrates become legal on October 17, 2019. Their legalization will mean seven classes of cannabis products will be approved for sale in Canada, as dried cannabis, cannabis oil, fresh cannabis, cannabis plants, cannabis plant seeds, were legalized in 2018. The speed with which Canada’s cannabis industry has evolved over the past 18 months has been truly remarkable.

In this, our third annual report on Canada’s cannabis industry, Deloitte has taken a broader approach in our research. As in previous years, we conducted comprehensive market research to understand Canadian consumer sentiment on cannabis edibles and other alternative products coming with Cannabis 2.0 legalization. The introduction of these new products is creating new opportunities in product mixes, reaching new cannabis consumers not fully comfortable with traditional consumption methods currently available.

As well, we explore trends and issues affecting the cannabis sector, drawing on extensive interviews and conversations with stakeholders across the industry. Where possible, we leveraged Deloitte's recent strategic alliance with Headset, the leading cannabis data and analytics provider, and Nielsen, a global measurement and data analytics company,¹ to draw on US data in order to compare and contrast the Canadian and US cannabis markets. Finally, we offer our perspective on how companies can win in the cannabis market while the industry is still forming. We believe that cannabis players need to build strong business fundamentals as the regulatory and business environment settles, requiring patience, perseverance and confidence—along with a well-developed business strategy backed up by hard data.

There will be missteps, delays, and frustration. This is to be expected in an industry that just launched and is becoming more adept at navigating the need to balance consumer education and consumer experience while operating in a tightly regulated market.

Our research suggests that the new alternative cannabis products becoming legal in late 2019 will be a significant opportunity for players in the cannabis market. The new options will address consumer interest among current and likely Canadian cannabis consumers. Deloitte estimates that the Canadian market for edibles and alternative cannabis products to be worth C\$2.7 billion annually—with cannabis extract-based products including edibles accounting for C\$1.6 billion alone. Eleven percent of Canadians already consume cannabis edibles and other alternative products, and 13% of Canadians are expected to buy them, as edibles and other alternative products that offer a more discreet and accessible way to consume cannabis and avoid any stigma surrounding smoking cannabis. With almost one in four Canadians consuming or likely to consume cannabis edibles and other alternative cannabis products, legalizing these products should clearly create valuable new growth opportunities for Canada's cannabis sector. It will also help maintain Canada's leadership position in an industry where the top cannabis markets globally² are, by Deloitte's estimate, worth US\$100 billion today—reaching US\$194 billion by 2025.³

Diligence and patience will be needed across the Canadian market as the regulatory framework for edibles and alternative cannabis products evolves in the runup to October 2019. As the industry settles, Deloitte believes the strong growth potential for legal edible products will drive increased mergers and acquisition activity in the industry.

However, we do need to acknowledge that Canada's legal recreational cannabis industry is still in its infancy. "Cannabis 1.0" legalized combustible cannabis, cannabis oils, and cannabis plants and seeds only a few months ago, and provincial governments, licensed producers, licensed retailers, R&D facilities, analytic testing facilities, financial institutions, and consumers are still navigating this new landscape. Cannabis 2.0 will undoubtedly be a "slow burn" at first, but as more products become available we're confident it will catch fire and gain momentum. Cannabis 2.0 will position Canadian companies and talent for global growth—even as the US market gains momentum.

There will be missteps, delays, and frustration. This is to be expected in an industry that just launched and is becoming more adept at navigating the need to balance consumer education and consumer experience while operating in a tightly regulated market. All the players involved share the same goal: to nurture a safe, controlled and thriving industry that protects consumers, creates jobs, and generates economic activity at home and abroad. If Canada chooses to be bold and capitalize on the early advantages it currently enjoys, Canada could seize the opportunity to lead the way.

About our research

The research for our third annual look at the Canadian cannabis industry comprises three parts.

- Deloitte conducted an online survey of 2,000 Canadian adults about their current and intended use of edibles containing cannabis, cannabis concentrates, cannabis-infused beverages, and cannabis topical ointments or creams, tinctures, and capsules. The survey was conducted between February 26 and March 11, 2019, and was designed to be nationally representative in terms of age, gender, and geographic region.
- In March 2019, Deloitte professionals conducted in-person interviews with a number of individuals closely connected to Canada's burgeoning cannabis industry. They shared their insights on the cannabis industry from a variety of perspectives: government regulators, industry associations, licensed producers, investment advisors, cannabis retailers, and cannabis innovators.
- Through Deloitte's strategic alliance with Headset, the leading cannabis data and analytics provider,⁴ we accessed point-of-sale data from cannabis retailers in Colorado, Washington, Nevada, and California for the period between March 2016 and February 2019. This data provided insights into US experiences around cannabis legalization, which serve as a useful point of comparison with the Canadian market.

Our survey work is prospective, and based upon respondents' preferences and estimating the consumer market demand and market sizing.





Cannabis 2.0

Canadian survey insights

What do Canada's current and likely cannabis consumers expect from Cannabis 2.0? What products are they most interested in? How much are they likely to spend on these new products—and to what extent will that spending take away from their spending in other areas such as alcohol? To gain insights into what Canadian cannabis consumers are thinking, we undertook a survey of 2,000 Canadian adults in early 2019, comparing the data with information provided by Headset to identify similarities and differences between US and Canadian markets.



Edibles and extracted products to power Cannabis 2.0 market

Deloitte estimates that the annual Canadian market for edibles and alternative cannabis products is worth C\$2.7 billion. The vast majority of this burgeoning Cannabis 2.0 market will be cannabis extract-based products, including edibles, which we estimate at C\$1.7 billion alone. Yet there is significant opportunity elsewhere, including cannabis-infused beverages (C\$529 million), topicals (C\$174 million), concentrates (C\$140 million), tinctures (C\$116 million), and capsules (C\$114 million).⁵

Realizing this sizeable market potential will take some time, since many of these products may not be available— or available in sufficient quantity— come October.

The second segment stakeholders expect to see take shape will include novice or “cannabis-curious” consumers—an older group, often female, who had little interest in combustible cannabis products and preferred to wait for Cannabis 2.0 offerings. In our 2018 report, we identified a similar demographic—the “conservative experimenter,” typically middle-aged and university educated, focused on family needs or other responsibilities, and more likely to consume cannabis less than once a month.⁷ These consumers are expected to gravitate towards more familiar formats, especially edibles such as baked goods, confectionary, and teas. The low dosages available in edibles and microdosing are ideal for these consumers, offering a more comfortable launching point for their cannabis experience.



Industry stakeholders foresee shifts in consumer segments

The industry stakeholders we interviewed view Cannabis 2.0 as a catalyst that will see Canadian cannabis consumers diverge into two broad segments. One segment will comprise current, more experienced cannabis consumers—Millennial or younger consumers who already use flower products. In many ways, this demographic is likely to line up with the “risk taker” profile we identified in our 2018 cannabis report: young, typically with a high school or college education, often consuming cannabis several times a week.⁶ This group is expected to be more interested in potent cannabis concentrates that may not be available post-legalization.

The current and likely user



Likely Canadian cannabis consumers are especially eager to try three new cannabis formats on: edibles, topicals or ointments, and cannabis-infused beverages.

Likely Canadian cannabis consumers are especially eager to try three new cannabis formats on: edibles (59%), topicals or ointments (53%), and cannabis-infused beverages (37%). This represents a growth opportunity for cannabis-related businesses and a potential point of entry for established companies with this expertise, since current cannabis consumers tend to lean towards more traditional methods of consumption.

Edibles, topicals, infused beverages poised to be the hot new cannabis products

Use of alternative cannabis products among current and likely users

	Percentage of respondents who currently use on a weekly basis	Percentage of likely users who intend to use
 Flower	29%	NA*
 Vapes	11%	NA*
 Concentrates	9%	26%
 Edibles	8%	59%
 Pre-rolled joints	7%	NA*
 Topicals	7%	53%
 Tincture & sub-lingual	5%	23%
 Capsules	4%	28%
 Beverages	3%	37%

* These formats were not asked to likely users

Ontario men aged 18-34 appear to be the most likely to consume new edible products, while beverages and tinctures appeal more to a younger demographic. It’s a different story for topicals, which appeal to older consumers aged 55-75, women, and those in Quebec.

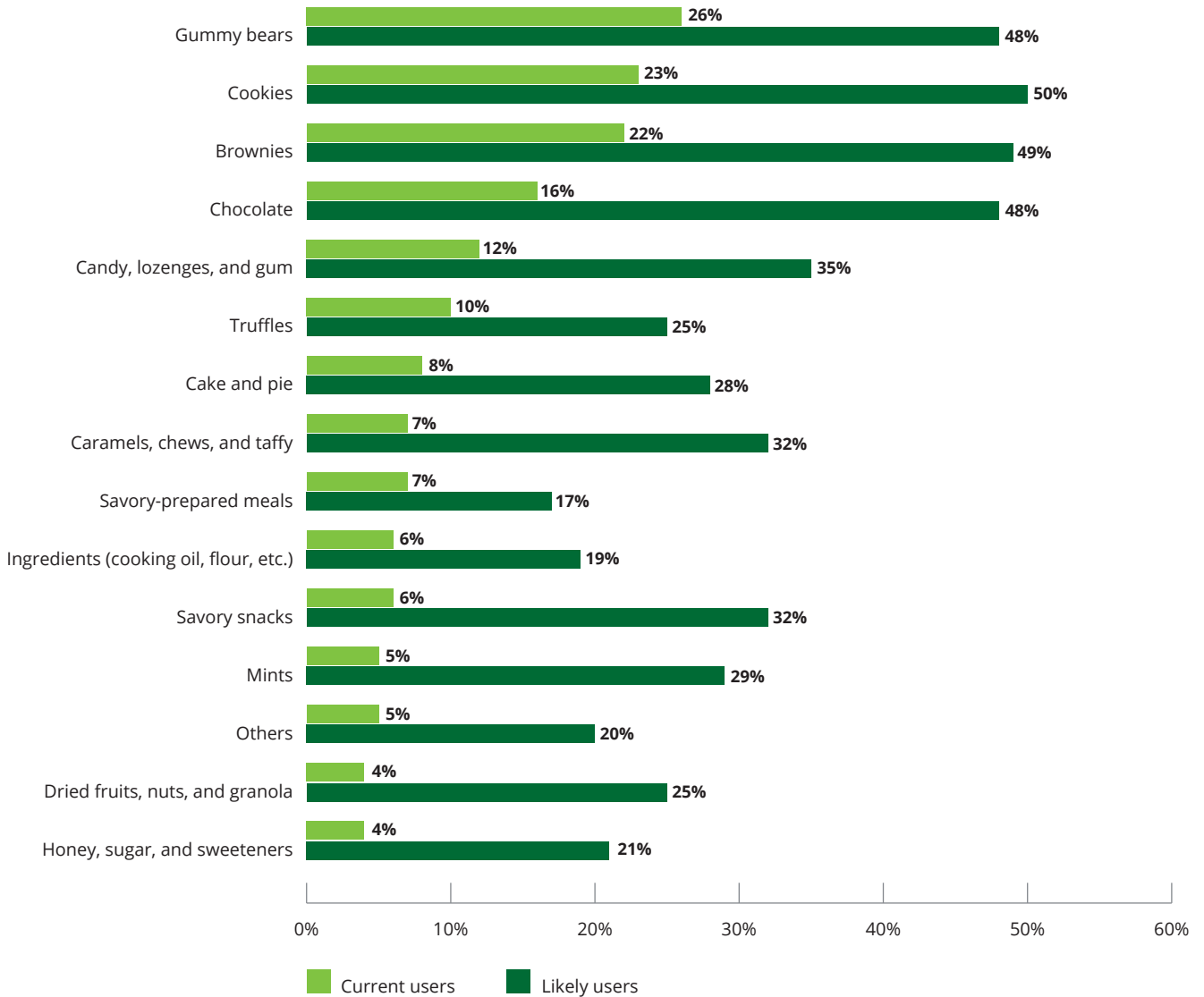
Gummies, anyone? Cookies?

While their interest in edibles may differ, current and likely cannabis consumers largely agree on preferred edible formats: gummies, cookies, brownies, and chocolates.

Current consumers rate cannabis gummies as their preferred edible format (26%), followed closely by cookies (23%), brownies (22%), and chocolates (16%). Cannabis cookies are likely consumers’ preferred edible (50%) by the narrowest of margins, with 49% interested in brownies and 48% likely to consume both chocolates and gummies.

Use of edibles by current and likely users

Percentage of respondents currently using
or are likely to use at least every 3 months



Canadian cannabis consumers are eager to try many forms of cannabis edibles.

Likely consumers appear to be much more interested in exploring a wide variety of edible formats compared to current consumers. While 35% of likely consumers are interested in cannabis candies, lozenges or gum and 32% say they'd try savory snacks, chews and taffies, current consumers aren't as inclined to do so: only 12% of current consumers are interested in cannabis candies; 7% say they'd consume caramels, chews, or taffy; and a mere 6% appear interested in savory cannabis snacks.

Regionally, consumers' preferences tend to mirror these nationwide figures, but there are some notable differences. Current consumers in Western Canada are more likely to consume cannabis-infused gummies (31%), cookies (25%), brownies (24%), candies (15%), and cakes and pies (11%) than their peers nationally. Current Ontario consumers are slightly more likely to consume cannabis cookies (26%). Current consumers in Quebec and Atlantic are less likely than their peers nationally to consume gummies (18% in each case), brownies (18% and 15% respectively), cookies (16% and 15% respectively), or chocolate (13% and 12% respectively).

Regional cannabis edible preferences among current consumers

Percentage of respondents currently using at least every 3 months

	Total	West	Ontario	Quebec	Atlantic
Caramels, chews, and taffy	7%	8%	5%	5%	9%
Cake and pie	8%	11%	6%	9%	6%
Truffles	3%	6%	3%	2%	3%
Ingredients (cooking oil, flour, etc.)	6%	10%	3%	4%	6%
Savory prepared meals	3%	2%	3%	4%	3%
Gummy bears	26%	31%	26%	18%	18%
Dried fruit, nuts, and granola	4%	4%	2%	6%	3%
Mints	5%	6%	3%	7%	6%
Brownie, blondie, and cereal bars	22%	24%	22%	18%	15%
Savory snacks	6%	8%	4%	7%	3%
Chocolate	16%	14%	20%	13%	12%
Cookies	23%	25%	26%	16%	15%
Honey, sugar, and sweeteners	4%	4%	3%	4%	3%
Candy, lozenges, and gum	12%	15%	9%	13%	12%
Other edible cannabis products	5%	8%	3%	3%	6%

Among likely cannabis consumers, those in Ontario are more likely than their national peers to consume brownies (53%), cookies (53%), chocolates (52%), and caramels, chews and taffy (37%). Likely consumers in Western Canada also display a slightly higher interest in gummies (51%) than nationally—but they're less interested in savory prepared meals (14%) or dried fruits, nuts, or granolas (22%). Likely Quebec consumers, on the other hand, are more likely than their national peers to try savory prepared meals (22%), but they're far less interested in gummies (37%) or caramels, chews, and taffy

(24%). Among likely Atlantic consumers, cookies are quite popular (56%) as are cakes and pies (33%), and fruits, nuts, and granolas (29%). However, Atlantic Canadians are decidedly not interested in cannabis savory snacks or mints (23% in each case), cooking ingredients (15%), or honeys and other sweeteners (13%).

While Canadian cannabis consumers—especially likely ones—are clearly eager to try many forms of cannabis edibles, it's clear that cannabis companies will need to manage expectations, since the edible formats Canadians want may not all be available in October.

Regional cannabis edible preferences among likely consumers

Percentage of respondents currently using at least every 3 months

	Total	West	Ontario	Quebec	Atlantic
Caramels, chews, and taffy	32%	33%	35%	24%	37%
Cake and pie	28%	25%	28%	29%	33%
Truffles	25%	24%	26%	25%	25%
Ingredients (cooking oil, flour, etc.)	19%	16%	20%	21%	15%
Savory prepared meals	17%	14%	18%	22%	15%
Gummy bears	48%	51%	51%	37%	48%
Dried fruit, nuts, and granola	25%	22%	27%	25%	29%
Mints	29%	27%	31%	31%	23%
Brownie, blondie, and cereal bars	49%	48%	53%	47%	42%
Savory snacks	32%	30%	37%	28%	23%
Chocolate	48%	45%	52%	42%	50%
Cookies	50%	47%	53%	47%	56%
Honey, sugar, and sweeteners	21%	22%	22%	22%	13%
Candy, lozenges, and gum	35%	35%	35%	36%	31%
Other edible cannabis products	20%	21%	21%	16%	21%

Where do you consume cannabis—and with whom?

	Current consumers	Likely consumers
With a small group of friends	54%	56%
With a partner/family member at home	43%	55%
Alone at home	35%	48%

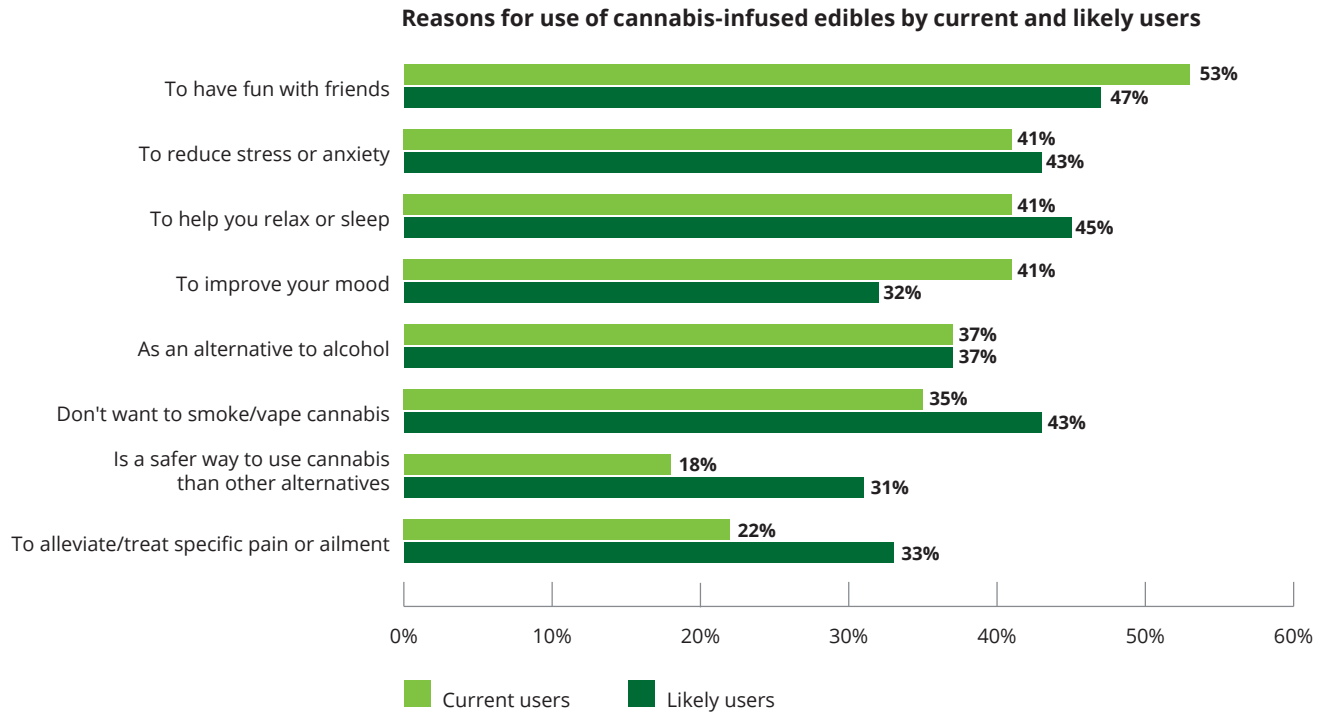
In fact, safety is rated as likely consumers’ most important consideration across all edible formats, followed by product quality and being Canadian-made.

Likely consumers see edibles as safer alternative and would rather buy than make
Canadian cannabis consumers say safety (66%) and product quality (52%) are the most important considerations when buying edibles. Nearly half (45%) of consumers say they'll look for products that provide the level of potency they want.

For nearly one in three likely cannabis consumers, edibles such as cannabis-infused beverages are seen as a safer alternative to other products. Interestingly, product safety is also more important to female and older consumers; being Canadian-made is also more important to likely consumers over 35. The majority of survey respondents say they intend to purchase edibles from government stores, licensed private retailers, or licensed producers and manufacturers directly.

Both current (53%) and likely (47%) consumers see edibles as a product to be consumed socially among a small group of friends. Nearly half (48%) of likely consumers say they'd consume alternative cannabis products at home, compared to 35% of current consumers. Likely consumers are also more likely (55%) to consume products with a partner or family, compared to 43% of current consumers. This speaks to likely consumers’ desire to try cannabis products in a safe space—but it also reflects the fact that likely consumers more commonly cite relaxation, sleep, and stress or anxiety relief as a reason for consuming cannabis products.

It is notable that current edible consumers say they are more likely to buy premade cannabis edibles rather than make their own—mainly because it’s more convenient, according to 80% of current consumers. Those consumers who do prefer to make their own edibles say they do so to control the dose (71%) and be assured of cannabis quality (54%).



Not surprisingly, brand does not yet play a key role in shaping consumers' edible preferences; only 13% of respondents say they look for a familiar brand. However, we do not believe this reflects the *potential* for brands to become an important force in consumers' path to purchase in the years to come. Likely consumers also do not appear to be particularly price sensitive at this point: only 25% say they look for the lowest-price products.

As well, only 17% of consumers look for organic cannabis products—though organic products may be more important for those buying ingredients for home-made edibles (e.g., honeys and cooking oils) than those buying premade edibles.



Terpenes could be an opportunity to educate consumers—and differentiate products

Terpenes are the diverse aromatic oils that give cannabis its distinctive smell as well as other unique scents such as pineapple, strawberry, and coffee—yet they are relatively unknown among consumers. Only 14% of likely consumers say they're aware of terpenes, while 14% of current consumers feel they are an important consideration in choosing products. Younger likely current consumers are slightly more aware of terpenes (21% and 17%, respectively).

This suggests that a useful opportunity exists for the industry to educate consumers about how terpenes impact cannabis product taste—while giving cannabis companies a means to differentiate products in various categories.

Will edibles cannibalize spending in other areas? Not yet. And that means growth.

Both current and likely consumers see cannabis gummies—which are widely available and readily accessible via with illicit market—as the most expensive edible product. Current consumers report spending nearly \$16 monthly on gummies, more than on other edible categories.

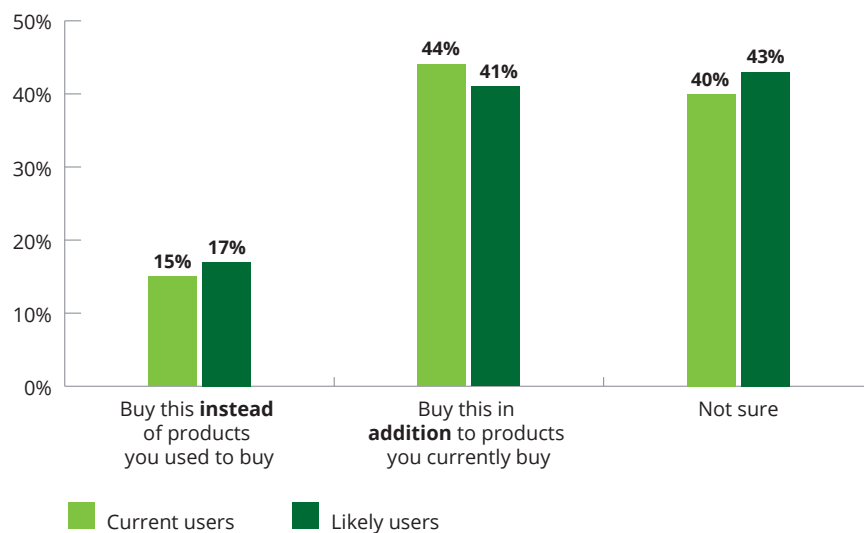
However, the industry stakeholders we spoke to believe it's highly unlikely that cannabis gummies will be made legally available. Likely consumers expect to spend slightly more (\$14.50) per month on cannabis-infused cookies, just slightly more than they anticipate spending on brownies (\$13.92) or chocolate (\$13.36).

Will Cannabis 2.0 cannibalize Cannabis 1.0 sales? Not yet, according to our research. Fewer than one in five current or likely respondents say their edible spending would replace spending on other products. Nearly half say they'll buy edibles as well as the products they're already buying—and a similar proportion aren't sure. This suggests that Canada's domestic cannabis market has room to grow.

Reasons for use of cannabis-infused edibles by current and likely users

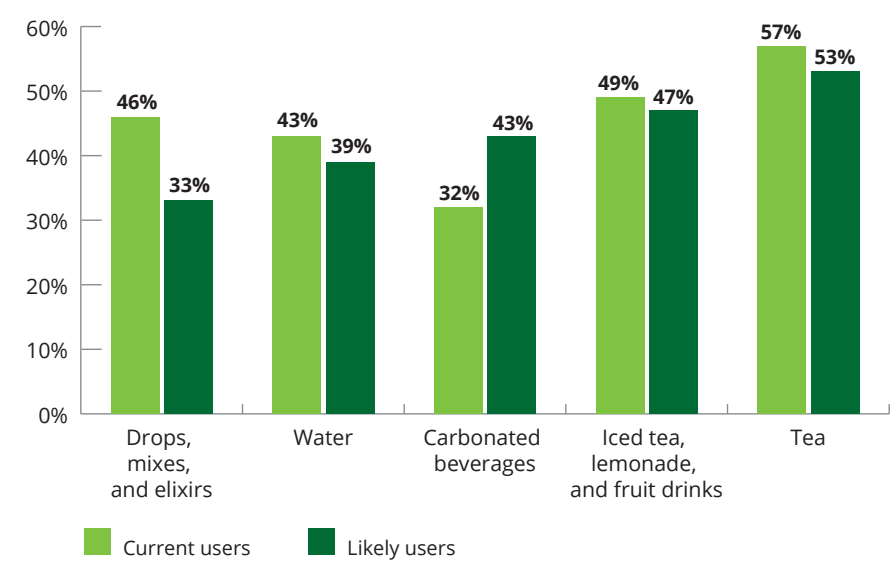
	Gummies	Brownies	Chocolate	Cookies
Current users	\$15.84	\$10.34	\$11.57	\$13.40
Likely users	\$18.79	\$13.92	\$13.36	\$14.50

Percentage of respondents who are current or likely users and will buy cannabis-infused edibles



Use of cannabis-infused beverages by current and likely users

Percentage of respondents currently using or are likely to use at least every 3 months

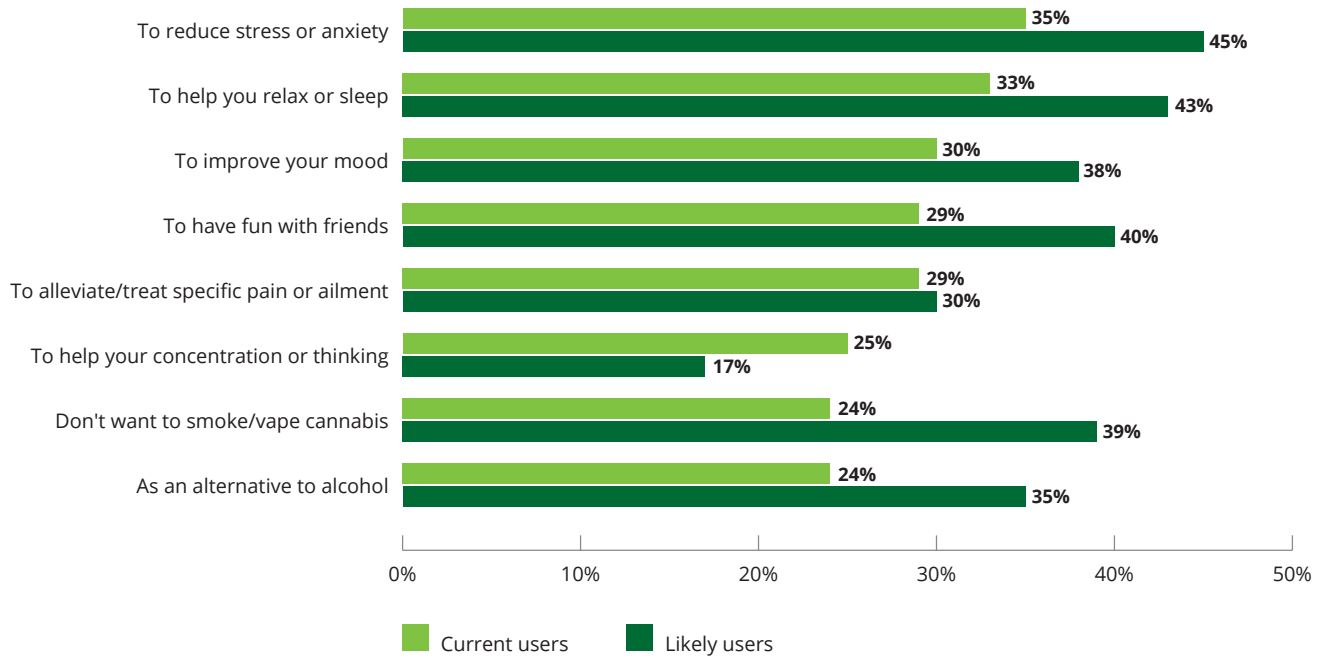


Cannabis beverages: Tea’s hot, mixing your own is not

Canadian cannabis consumers really like their cannabis-infused tea—it’s the most popular cannabis beverage choice of both current (57%) and likely (53%) consumers, especially among older consumers. Among likely consumers, hot and iced cannabis beverages appeal equally to men and women. Likely consumers would prefer to buy pre-made cannabis-infused beverages; current consumers, on the other hand, appear quite comfortable using drops, mixes, or elixirs to mix their own beverages. This isn’t surprising, given likely consumers’ concerns over product safety and potency.



Reasons for use of cannabis-infused beverages by current and likely users



Cannabis-infused beverages: At home with friends or family, say likely consumers

One in three (35%) likely cannabis consumers see cannabis-infused beverages as an alternative to alcohol—perhaps seeing cannabis beverages as a way to relax, sleep, alleviate stress or anxiety, lift their mood and have fun with friends without the risk of a hangover the next day. Slightly more likely users (39%) see beverages as a way to avoid smoking or vaping cannabis.

Current and likely cannabis consumers prefer drinking cannabis beverages at home, but likely consumers tend to prefer to do so in a more social setting. More than half of likely consumers say they'd consume cannabis-infused beverages at home with their partner or family members (59%) or friends (55%), compared to 41% and 34% of current consumers, respectively.

In choosing cannabis beverages, likely consumers prioritize product quality (52%), safety (50%) and potency (47%). A sizeable number of current (27%) and likely (22%) consumers say they also consider the organic nature of the product in making their purchase decision. When it comes to making the purchase, most consumers again prefer to buy products from government retailers (54%), licensed private retailers (53%) or licensed producers or manufacturers (46%).

Cannabis-infused beverages, it appears, offer another route to incremental growth for the Canadian cannabis market.

Cannabis-infused beverages unlikely to cut into sales of other cannabis products

Cannabis consumers’ spending on cannabis-infused beverages will probably complement, not replace, their spending on other cannabis products, according to our survey. Forty-four percent of current cannabis consumers and 53% of likely consumers say they will buy beverages in addition to other cannabis product. Cannabis-infused

beverages, it appears, offer another route to incremental growth for the Canadian cannabis market.

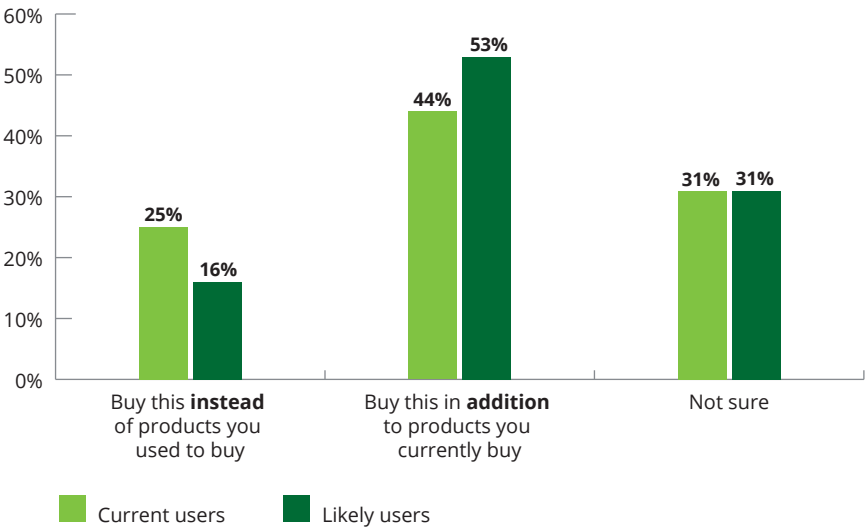
Current consumers who are more comfortable mixing their own cannabis beverages report spending far more on drops and similar products than pre-made beverages. Likely consumers expect to spend slightly more on cannabis-infused teas than on other beverages.

Reasons for use of cannabis-infused beverages by current and likely users

Average monthly spend on cannabis-infused beverages

	Tea	Water	Drops	Iced tea
Current users	\$ 13.85	\$24.21	\$35.49	\$19.83
	Tea	Water	Carbonated beverages	Iced tea
Likely users	\$18.93	\$18.90	\$16.29	\$14.57

Percentage of respondents who are current or likely users and will buy cannabis-infused beverages



Increasingly popular cannabis topicals poised to muscle in on prescription medication's turf

Cannabis topicals—including lotions, salves, gels, and creams—are popular among both current and likely cannabis consumers. Thirty four percent of likely cannabis consumers say they expect to use cannabis lotions at least every two weeks, roughly the same percentage of current consumers already do. The overwhelming majority (71% of current consumers and 79% of likely consumers) use or plan to use topicals to alleviate or treat specific pain. The growing use of cannabis as a wellness product or to alleviate pain isn't surprising: Canadian cannabis industry stakeholders have worked together to create an industry-wide, globally scalable traceability framework

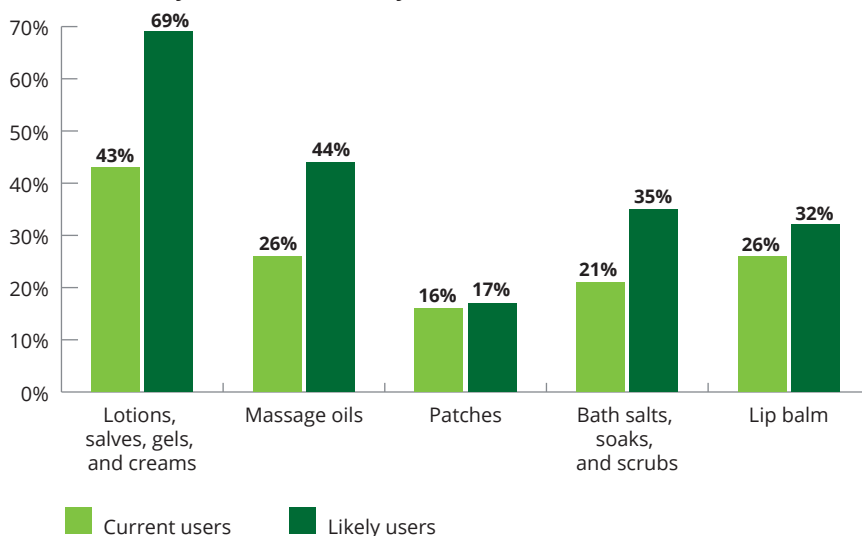
to ensure a safe, efficient global cannabis chain that would extend to the genetic composition of the cannabis strain itself. This could be cause for concern for the traditional pharmaceutical sector, as 45% of current consumers and 48% of likely consumers say they see cannabis topicals as an alternative to prescription medications, not a complement.

Current consumers say they spend an average of \$21.22 on topicals each month, while likely consumers expect to spend slightly more—\$23.81—on topicals once they're legalized. Not surprisingly, consumers' main purchasing criteria are safety (70%) and quality (56%), and more than half choose to buy topicals from legal government or licensed channels.

When it comes to choosing cannabis-infused topicals, consumers place significantly more importance on product safety and Canadian origin than they do compared to edibles or other products. Product quality and potency are also important criteria—as is whether or not a topical is organic. Brand and price don't appear to play much of a role in shaping consumers' topical choices yet, though we would expect to see that change in the future.

Use of cannabis-infused topical products by current and likely users

Percentage of respondents currently using or are likely to use at least every 3 months



Tinctures, concentrates, capsules generate consumer interest but no clear winners emerge

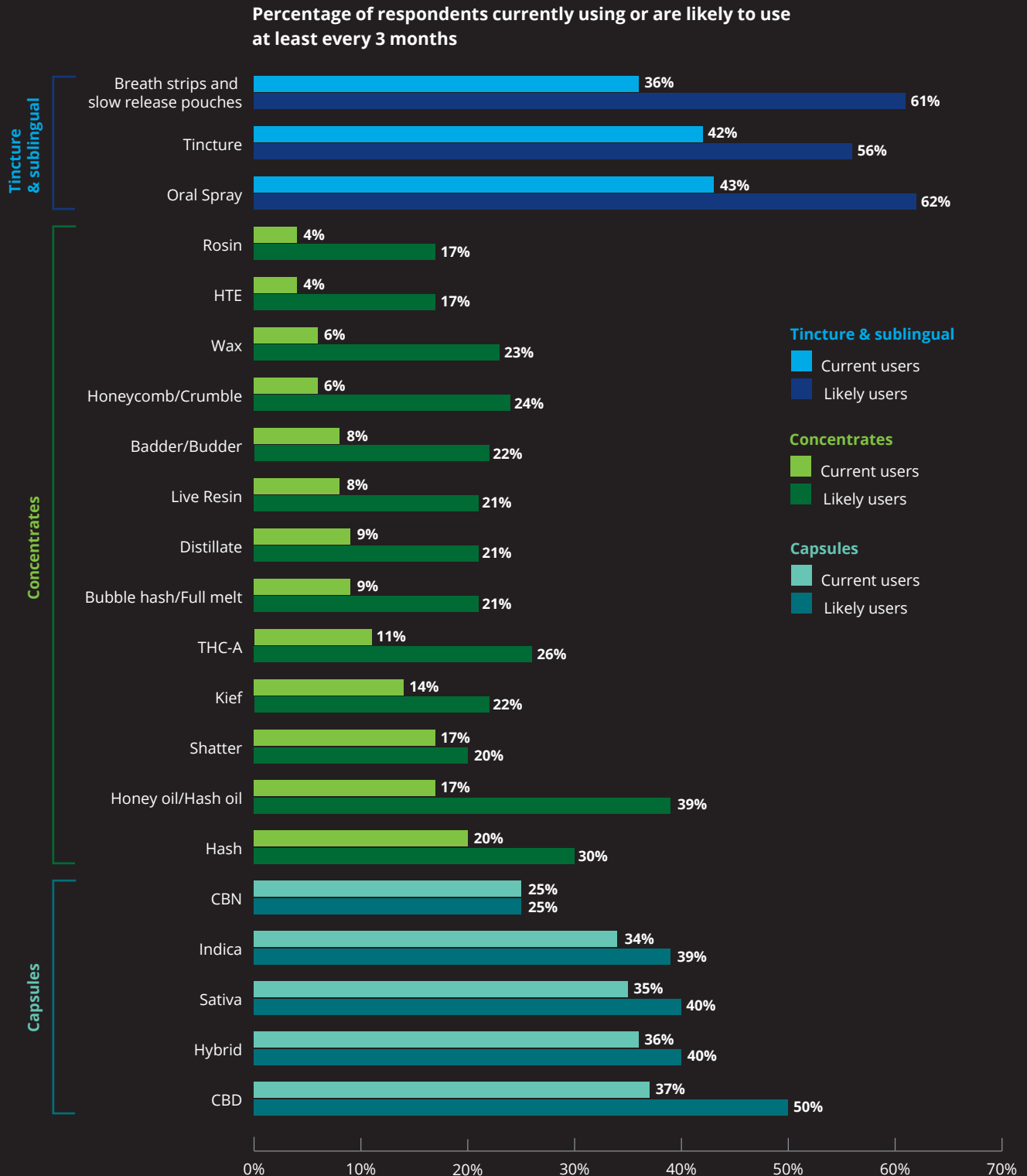
There's more to Cannabis 2.0 than edibles, beverages, and topicals, of course. Tinctures and sublingual products have clearly captured the interest of likely cannabis consumers, with nearly two-thirds saying they're likely to use such products at least every three months (roughly 40% of current consumers already do so.) No one format in this subcategory is especially predominant, perhaps reflecting likely consumers' curiosity or an opportunity for product education and differentiation.

Cannabis capsules are relatively popular among current and likely consumers, likely because they can be tailored for strains (e.g., indica, sativa) or specific cannabinoids (e.g., CBD, CBN) and consumers feel they can dose consistently to achieve a specific effect. Here too, no one product emerges as the leader, although likely users appear slightly more inclined to try CBD capsules.

Currently, concentrated cannabis products such as rosins, waxes and shatter don't appear to hold the same appeal for current or likely cannabis consumers, though hash and hash or honey oils do seem slightly more popular. This may simply be due to consumers' lack of familiarity with the range of cannabis concentrates available. These products are predominantly consumed by medical cannabis consumers in the US; it may be that Canadian medical cannabis consumers will turn to these products once they're available. If so, it could prove a significant opportunity for cannabis companies.



Use of alternative cannabis-infused products by current and likely users



Perspectives on Cannabis 2.0

Strong consumer demand for and interest in alternative cannabis products—especially edibles and wellness-related products—suggests that Cannabis 2.0 will, in time, prove to be a strong source of revenue growth for Canada’s cannabis sector. Government and industry players alike have learned lessons from the first phase of legalization in 2018, and there is a shared commitment to delivering an improved rollout with Cannabis 2.0. There will be missteps and growing pains, and it will take time before Canadian cannabis consumers have access to the full range of alternative cannabis products. Yet these momentary stumbles are to be expected as the country nurtures an industry that is not even a year old in its legalized incarnation.



The fact remains that Canada is a leader in a fast-growing global industry. Canada's cannabis cultivators, processors, testers and retailers continue to have important competitive advantages over their counterparts in more restrictive jurisdictions—but first-mover advantage has a shelf-life. As other countries legalize or decriminalize recreational and medical cannabis to varying degrees, Canadian firms should move fast to secure their place at the forefront of the global industry. Canada has a unique opportunity to demonstrate how to roll out cannabis effectively and safely while managing and aligning stakeholders' expectations.

The size of the global cannabis opportunity is enormous, and Canada's to seize

Concerns over the potentially slow pace of Cannabis 2.0's rollout in Canada overlook one very important fact: the Canadian market represents only a small portion of the global cannabis opportunity.

Deloitte estimates the Canadian market for legal recreational and medical cannabis to be worth CDN\$2.6 billion to CDN\$6.13 billion overall. Recreational cannabis accounts for CDN\$1.81 billion to CDN\$4.34 billion of that potential market, with medical cannabis accounting for CDN\$0.77 billion to CDN\$1.79 billion. Introducing alternative cannabis products will enable Canadian companies to realize even more of that potential market in the months and years to come.⁸

Canada reaps the benefit of a fast-growing global industry. Canadian cannabis companies wisely appear to be focused on winning on the global stage.

Investors, banks and capital markets are all contributing to the rapid growth of the cannabis industry. And Canadian cannabis companies, supported by Canadian regulatory policy, are actively pursuing joint ventures, partnerships, and acquisitions from the US and South America to Europe and Africa. Global cannabis technology hubs are forming in the US and Israel, spurring a new generation of investment and innovation, and Canada is deeply involved there as well. All of this international activity will help ensure Canada reaps the benefit of a fast-growing global industry. Canadian cannabis companies wisely appear to be focused on winning on the global stage.

Cannabis sector to stay M&A's "wild west"—for now

Cannabis M&A activity continues at a furious pace. In 2018, there were over 700 transactions completed in the cannabis sector, with a combined value of more than US\$12 billion. Canadian licensed producers are among the most active, as they continue to pursue deals to obtain scale, improve vertical integration, focus on particularly attractive value chain segments, and expand into new markets around the globe.

Alcohol and tobacco companies have also begun searching for growth through M&A, and they are eager to avoid losing market share to competing cannabis products. Pharmaceutical companies are making their own cannabis plays as consumers turn to CBD and other cannabis products to manage various health and wellness issues. Consumer packaged goods and food and beverage companies are moving in to capitalize on consumers' interest in cannabis beauty products, edibles, beverages and other products. These traditional companies will bring scale, brand, and immense customer insights to bear on cannabis.

Cannabis company valuations are likely to remain elevated—for now—and influenced by historically higher valuations in prior transactions. Most transactions in FY18 were paid for using (elevated) stock, which has also contributed to higher valuations. The "gold rush" sentiment surrounding the cannabis sector is another factor playing a role in the valuations we're seeing, if a less rational one. At this point in time, valuation multiples on trailing earnings may not be meaningful, since heavy investments in facilities, distribution networks, and research and development mean that many cannabis companies have negative earnings.

As the industry matures, we expect M&A activity to slow and valuations to normalize. There will likely be some consolidation in the Canadian industry to absorb excess capacity, and there is an expectation that the number of Canadian licensed producers will fall to almost half the current level. Until then, investors should undertake careful analysis of the risk and benefits inherent to each segment of the value chain relative to the overall cannabis opportunity, since multiples may differ depending where on the value chain a company sits. Due diligence must expand beyond the traditional analysis of financial and operational integrity. Financial institutions require significantly more transparency regarding ultimate beneficial owners of entities involved in the cannabis supply chain—there are lots of speculators—and “know your customer” (and your customer’s customer) is key to adhering to anti-money laundering requirements.

US experience is no sure guide to the future of Cannabis 2.0 in Canada

Some industry observers believe that US state cannabis markets provide a glimpse of the future of Canada’s cannabis industry. This is a common mistake when assessing the Canadian market. In many industries, particularly retail, Canadian consumers aren’t like their US counterparts. As such, we believe the US experience offers an interesting comparison, but not a guide.

Through Deloitte’s strategic partnership with Headset and Nielsen, we looked at point-of-sale data for cannabis retailers in Colorado, Washington, Nevada, and California from March 2016 to February 2019. Edibles and concentrates are the most popular categories of cannabis product, after combustible cannabis. Overall, edibles accounted for 26% of sales of non combustible cannabis in the four states. The US data also suggests that as

markets mature and consumers learn more about the products available, they—particularly medical cannabis consumers—migrate to concentrated products such as shatter, wax and resin. Indeed, concentrate sales growth has outpaced overall market growth in both Colorado and Washington—which has stood at 25% per year since 2016. Meanwhile, cannabis beverages have lagged behind other products, though this may be in part due to the fact that it is difficult for beverage makers to achieve the kind of scale needed to make an impact on the market.

Yet these figures fail to reflect key differences between the US and Canadian cannabis experiences. US cannabis firms must currently operate at a comparatively local level due to restrictive and non-uniform state-by-state regulation. This prevents US players from scaling to efficiently distribute their products nationally.

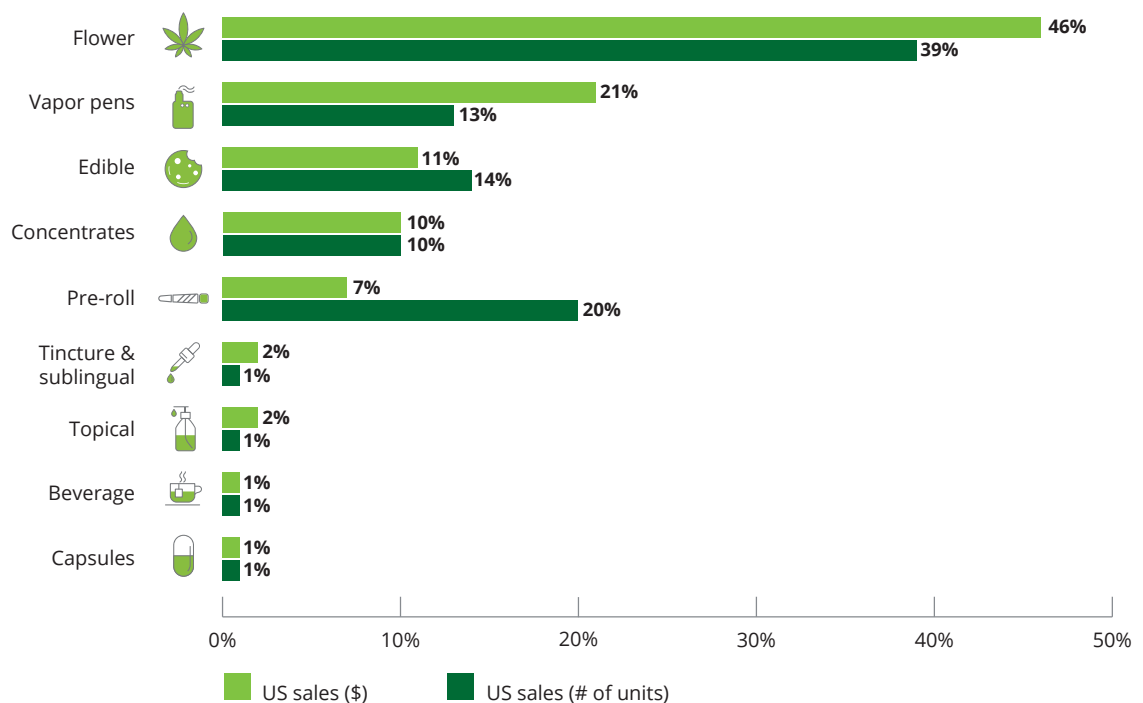


The industry stakeholders we spoke with expect to see Canadian consumers move away from dry flower over the next three years, and believe products from cannabis concentrates, including confectionaries and beverages, will be the most successful categories overall.

Our view is that edibles will prove to be a more successful segment in Canada, in part because the Canadian market is currently more scalable than the US market. Edibles will make cannabis more accessible to a wider group of Canadians, many of whom will appreciate edibles' discreetness and lack of surrounding stigma. They will be a more profitable product line for retailers, who will also be able to leverage a wide assortment of edibles to provide the customer experience consumers crave and differentiate themselves in the market. As producers and retailers bring more edibles to market over time, they will capture an ever larger share of consumer spend—and contribute to a shrinking illicit market.

The industry stakeholders we spoke with expect to see Canadian consumers move away from dry flower over the next three years, and believe products from cannabis concentrates, including confectionaries and beverages, will be the most successful categories overall. Topicals and ointments, especially CBD varieties, will be a highly important category as well, appealing to new cannabis consumers who are especially interested in cannabis' wellness benefits. The extent to which these projections come to pass will ultimately depend on how Canada's cannabis regulations develop over time, of course.

2018 U.S. cannabis sales
(Value – \$ vs. volume – # of units)



But that doesn't mean Canada shouldn't worry about global competition

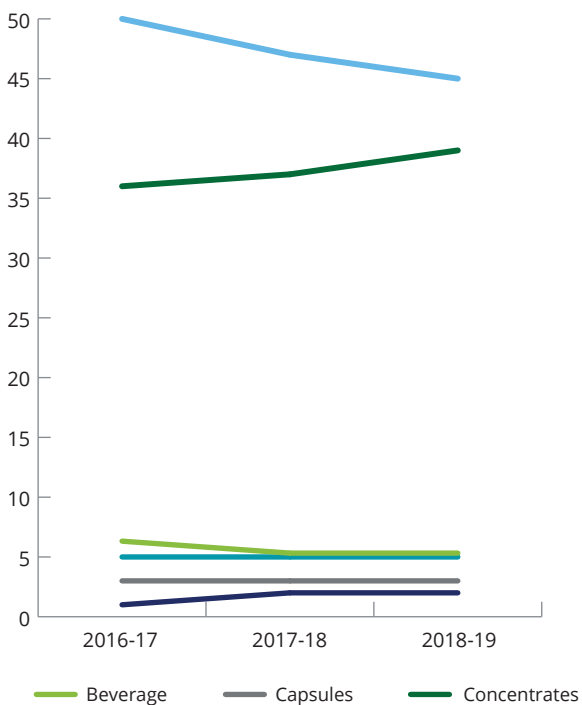
Canadian cannabis companies currently enjoy enormous advantages over their US and global counterparts in a number of important ways, particularly in terms of government support and access to capital markets and a banking system. However, Canada's cannabis-related businesses need to pay close attention to their financial banking arrangements to ensure they don't fall afoul of complex global financial payment regulations. Those operating in the EU, for example, must navigate the trading bloc's complex banking regulations while also navigating cannabis legislation that varies by member state.

Canadian companies must not become complacent about the US, either. In December 2018 the Farm Bill was signed into law. This bill removed hemp, an important ingredient for low- or non-THC CBD products, as a controlled substance—and the US CBD market is estimated to become a US\$16 billion opportunity by 2025. With the stroke of a pen, US hemp growers now have access to the banking system, crop insurance, agronomy research, and conventional business practices. The US Food and Drug Administration and Department of Agriculture hope to have new rules related to hemp in place for the 2020 growing season. Ten states, as well as the District of Columbia, have now legalized

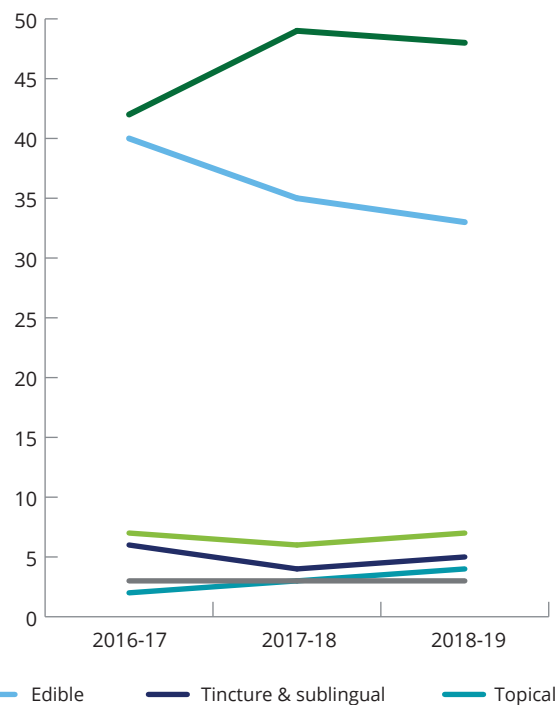
recreational cannabis, and 13 other states have decriminalized cannabis. Thirty-three states have legalized medical cannabis. If US federal cannabis legalizations happens, Canadian companies who have not secured a strong, sustainable competitive position by that time risk being overwhelmed.

The passage of the Farm Bill also adds new layers of complexity and risk to the banking landscape. Banks will need to consider cannabis clients at a state-by-state level, which will be highly difficult to operationalize.

Colorado product mix/market evolution
Percentage of volume (# of units) sales



Washington product mix/market evolution
Percentage of volume (# of units) sales



Product innovation can open up new opportunities in food and beverage, beauty, health and wellness.



Innovation will be key to sustaining Canada' competitive advantage

If Canada is to maintain a competitive advantage in cannabis over the long term, it must create an industry environment that fosters innovation and scientific research. The capital markets, scientific community, and government regulators must align and work together to create unique intellectual property for cannabis and ancillary industries that support it.

Cannabis companies are not permitted to brand, but they can leverage customer data and analytics to provide personalized, direct-to-consumer recommendations, gain detailed insight into consumer behaviours and preferences, and run their businesses more effectively. Leveraging an end-to-end view of both customers and the production process will be key in winning in the market and attracting customers from the illicit market.

Product innovation can open up new opportunities in food and beverage, beauty, health and wellness. Developing or acquiring new intellectual property, from technology to genetics, will play a vital role in helping companies set themselves apart in an increasingly crowded industry.

The stakeholders we interviewed expect new innovations to be a constant feature of the burgeoning cannabis industry. They foresee a company cracking the code that makes timed dosages possible. Plant scientists will find ways to improve cannabis' mould resistance. Cannabis and CBD will find their way into a new health, wellness, and beauty products. Pharmaceutical firms will move into the medical cannabis field to leverage their innovation capacity.



The way forward Thriving in a Cannabis 2.0 world

Cannabis 2.0 is the next important step in Canada's cannabis legalization journey, one that will keep our country—and Canada's cannabis industry—in the spotlight on the global stage. It's unlikely that the introduction of legal alternative cannabis products will set cannabis sales alight immediately. Instead, Cannabis 2.0 will begin at a slow burn, growing in brightness and intensity in the months and years to come. This is ultimately a positive, in that it will enable Canadian cannabis companies to get their business fundamentals right and add needed skills and resources to their business as they look towards further growth.

For Canada's cannabis industry to thrive in a Cannabis 2.0 world, cannabis companies—from cultivators and processors to testers and retailers—and governments alike must be bold, courageous, and forward-thinking.



- **Focus on business fundamentals.** Investors and entrepreneurs are all eager to get involved in the cannabis “gold rush,” and it’s all too easy to get carried away with the hype. Companies that focus on the fundamentals—managing risks and costs, understanding their customers, and executing on a clear strategy—will be the ones who survive and thrive in the long term.



- **Innovation is critical.** As the global cannabis market matures, Canada will inevitably lose its edge in certain parts of the value chain, notably cultivation. Innovation will be essential to ensure Canada’s cannabis companies capture a sustainable competitive advantage at key points along the value chain. Whether through R&D or acquisition, product, process, and consumer innovations and unique IP will be what sets Canadian firms apart from the rest—and keeps them there.



- **Insight-driven cannabis firms will win.** In an industry where companies can’t rely on traditional branding or marketing to reach consumers, data becomes incredibly valuable. Cannabis firms that invest in collecting cannabis consumer data and use analytics to discern key insights from that data will be able to make faster, smarter business decisions.



- **Consumer experience matters.** Data-driven insights can help cannabis companies anticipate and respond to consumer behaviours and preferences nimbly and effectively. This deep understanding of cannabis consumers and their path to purchase is essential to delivering the positive, tailored experience consumers now demand.



- **Accelerate the evolution of the cannabis industry without compromising public health and safety.** The Canadian government is committed to public health and safety, and to date the country has not experienced any major public safety issues surrounding cannabis. We understand the care and caution with which Health Canada is approaching the approval and introduction of new products. We are supportive of the industry-led initiative to establish an industry-wide, globally scalable traceability framework for cannabis, leveraging globally recognized standards, to ensure a safe, efficient cannabis supply chain in Canada that ultimately protects the consumer. We also encourage government and the industry to work together to find ways to accelerate the process of approving new cannabis products and to consider how to achieve a balance that would enable the cannabis industry to grow and create good jobs without compromising Canadians’ health and safety.

Remain bold

With the launch of Cannabis 2.0, Canada and the cannabis industry remain at the very forefront of cannabis legalization worldwide. The global cannabis market is enormous, and Canadian cannabis firms are very well-positioned to play a pivotal role as the market grows and evolves. Deloitte believes that companies with strong leadership, strong business fundamentals, a focused strategy—and a willingness to act courageously—will win.

Together, government and industry have worked together to boldly launch an entirely new industry and position it for success.

Now they must focus on innovation to secure long-term competitive advantage. Canada's cannabis industry needs to develop a more sophisticated, comprehensive, real-time "seed-to-sale" system, and use data to gain new insights into cannabis consumers and markets, shape new policies, and improve speed-to-market for new ideas and products. The industry acknowledges the need to achieve greater transparency—and wants to achieve this in order to generate confidence among regulators, financial institutions, customers, investors, and other stakeholders. Companies need to zero in on the parts of the value chain they're best positioned to thrive in, and pursue acquisitions and partnerships that will propel themselves forward. And all parties involved in the cannabis industry must move forward with determination, with focus, and with courage

Deloitte is confident that Canada's cannabis industry is focused on the tasks that lie ahead.

Contacts

Global cannabis practice leader

Jennifer Lee

Partner
National Cannabis Sector Leader
Consumer Advisory & Analytics
Practice Leader
jenniferlee@deloitte.ca

Global cannabis partner team

Rishi Malkani

Partner, Cannabis M&A
rmalkani@deloitte.ca

David Stewart

Partner, Financial Crime
davstewart@deloitte.ca

Bill Stamatis

Partner, Valuations
bstamatis@deloitte.ca

Sandeep Gill

Global Consumer Products Leader
Global Financial Advisory
sandeepgill@deloitte.co.uk

Rob Patridge

US Cannabis Specialist
rpatridge@deloitte.com

Special thanks

John MacLeod

Senior Manager
Customer Insights & Advisory

Jessica Rhee

Senior Manager
Analytics Data
Applications & Modelling

Gordana Maric, PhD

Manager
Customer Insights & Advisory

Swathi Sadagopan

Senior Analyst
Customer Insights & Analytics

Kris Hon

Endnotes

- 1 <https://www2.deloitte.com/ca/en/pages/press-releases/articles/announce-a-strategic-alliance.html>
- 2 Top global cannabis markets globally per Deloitte research include Canada, the US, Mexico, Australia, the UK, Italy, the Netherlands, Belgium, Switzerland, Germany, France, Poland, and Spain. These markets were determined based on both market opportunity and the current state of cannabis legalization.
- 3 Source: Deloitte research.
- 4 <https://www2.deloitte.com/ca/en/pages/press-releases/articles/announce-a-strategic-alliance.html>
- 5 Figures do not add to C\$2.7 billion due to rounding.
- 6 Deloitte, *A society in transition, an industry ready to bloom: 2018 cannabis report*
- 7 Ibid.
- 8 Ibid.
- 9 <http://www.cowen.com/reports/cowen-collective-view-of-cbd/>



Notes



www.deloitte.ca

Deloitte provides audit & assurance, consulting, financial advisory, risk advisory, tax and related services to public and private clients spanning multiple industries. Deloitte serves four out of five Fortune Global 500® companies through a globally connected network of member firms in more than 150 countries and territories bringing world-class capabilities, insights and service to address clients' most complex business challenges. To learn more about how Deloitte's approximately 264,000 professionals—9,400 of whom are based in Canada—make an impact that matters, please connect with us on LinkedIn, Twitter or Facebook.

Deloitte LLP, an Ontario limited liability partnership, is the Canadian member firm of Deloitte Touche Tohmatsu Limited. Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

© Deloitte LLP and affiliated entities.

Designed and produced by the Deloitte Design Studio, Canada. 19-6179T