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Caution on credit quality while Bill C-45 unleashed bull run in Canada's marijuana market

by Anthony Prayugo

Canada is set to become the second nation in the world to permit a nationwide marijuana market after its senate approved the Cannabis Act in June 2018. The Cannabis Act, also known as bill C-45, will allow the usage of cannabis for recreational purposes when previously it only legalize the usage for medical purposes. The bill allows the sale and possession of up to an ounce of marijuana for anyone over the age of 18. It was first introduced in April 2017 and will finally be put into effect from 17 October 2018. As a result, investors have channeled their capital into the marijuana market in recent months and Canada's major cannabis industry players such as Canopy Growth Corp and Aurora Cannabis Inc. saw their market capitalization increase by approximately 137% and 161% respectively from the beginning of the year. To capture the market optimism and further expand their business, the companies also raised debts amid negative cash flows thereby increasing the credit risk of the companies.

Investors are excited with the marijuana market for several reasons. Firstly, the legalization means the demand for marijuana will increase. A new report commissioned by Health Canada predicts the demand for cannabis / marijuana will be substantially higher than initially expected. The new estimate calculated that consumption of cannabis for both medical and recreational use will be 41% higher compared to what was estimated by the Parliamentary Budget Office in 2016, increasing from 615,000 kg to 926,000 kg in the first year of legalization. Consequently, experts predicted that the supply of marijuana will not meet the demand until 2020.

The legislation also provides new business opportunity for marijuana producers as they can now explore other business areas where they were not allowed to previously. In August 2018, Canopy announced a partnership deal with Constellation Brands, a leading beverage producer, to begin introducing cannabis infused drink. Furthermore, researchers at the University of Connecticut and Georgia State University suggested that marijuana and alcohol are strong substitutes. Their research found that US counties in states that permit the usage of marijuana saw their alcohol sales drop by 15%. If the same trend continues in Canada, it is no wonder that alcohol producers such as Constellation Brands are seeking partnership with marijuana producers to offset the predicted drop in alcohol sales.

These factors made investors very confident in the prospect of the marijuana market. Canopy and Aurora's revenue are predicted to increase more than tenfold by 2020 (see Table 1 and Table 2).

12 Months Ending		Mar 18	Mar 19 Est	Mar 20 Est
Canopy Growth Corp	Revenue (CAD mn)	77.9	355.1	911.7
	Operating Income (CAD mn)	-77.6	-67.4	94.7

Table 1: Revenue estimate data for Cannabis Growth Corp. *Source: Bloomberg*

12 Months Ending		Jun 18	Jun 19 Est	Jun 20 Est
Aurora Cannabis Inc	Revenue (CAD mn)	55.2	399	893.3
	Operating Income (CAD mn)	-80.1	NA	NA

Table 2: Revenue estimate data for Aurora Cannabis Inc. *Source: Bloomberg*

The recent surge of confidence in the marijuana market encouraged Canopy and Aurora to increase their investments before the legalization was put into effect. Both Canopy and Aurora's operating expenses soared as they were preparing for the impending domestic adult-use market on Oct 17, 2018. The increase was mainly due to investments in their brand strategy which also include one-time expenses related to the preparation for legalization. Furthermore, capital expenditures for both companies also increased as they expanded their cultivation capacity (see Figure 1a).

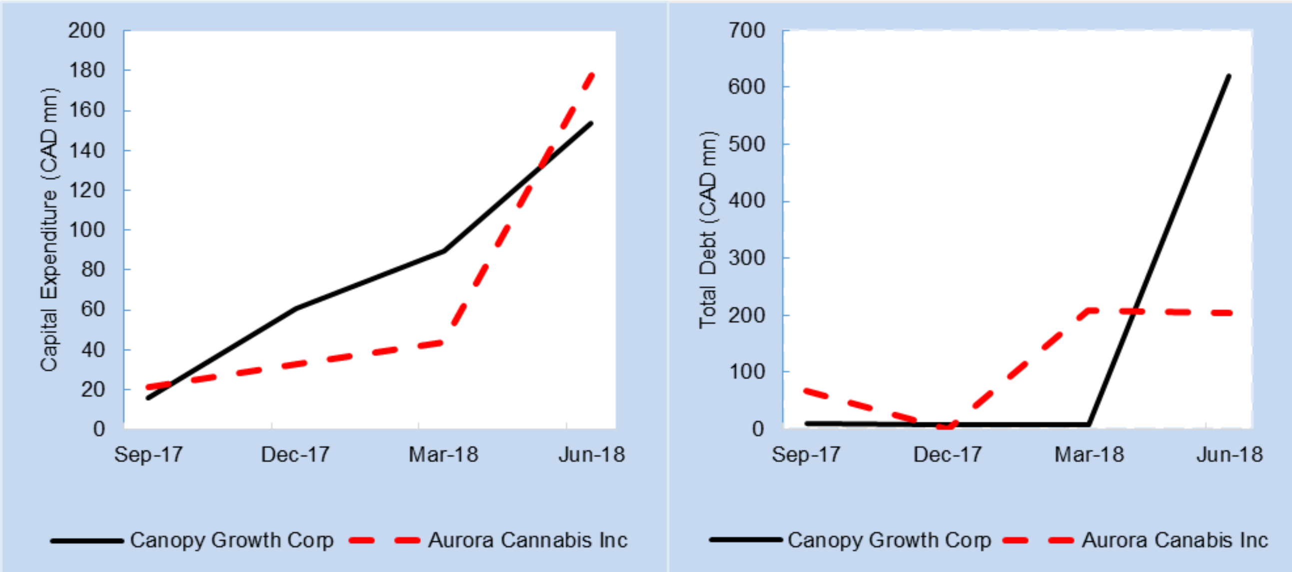

Figure 1a (LHS): Canopy Growth Corp and Aurora Cannabis Inc Capital Expenditure. Figure 1b (RHS): Canopy Growth Corp and Aurora Cannabis Inc Total Debt. *Source: Bloomberg.*

Not only was Aurora aggressive in expanding its own operations, but it was also aggressively pursuing M&A deals. In the past 2 years, it has acquired at least 10 companies to increase its production capacity. Moreover, it has also attempted to make inroads into the South American markets by purchasing ICC Labs, a licensed medical marijuana producer in Argentina and Uruguay.

In Figure 1b, Aurora's total debt grew to CAD 209mn in March 2018 and for Canopy, it rose significantly to CAD 620mn in June 2018 mainly to fund its expansion. Aurora had CAD 230mn of 5% unsecured convertible debt due 2020 which is trading at about 113% of face value. Meanwhile, Canopy Growth Corp CAD 600mn of 4.25% convertibles due 2023 are trading at around 150% of face value. The bullishness in the equity market for these marijuana players has also ignited interest in their convertible bonds. From the bond premium and the positive revenue estimates for both companies, investors might be invested for the long-term. However, Canopy and Aurora had approximately CAD -479mn and CAD -357mn free cash flows respectively in the recent earnings for 12 months ending in June 2018, indicating that investors need to exercise caution as the companies try to fulfil their short term obligations. Figure 2 below illustrates the term structure of the RMI-CRI Forward 1-year Probability of Default (PD) for the two marijuana producers on 5 October 2018. The Forward PD works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The figure asserts that the credit quality of both Canopy and Aurora might worsen, rising over the next few years, which coincides with their recent increase in debt.

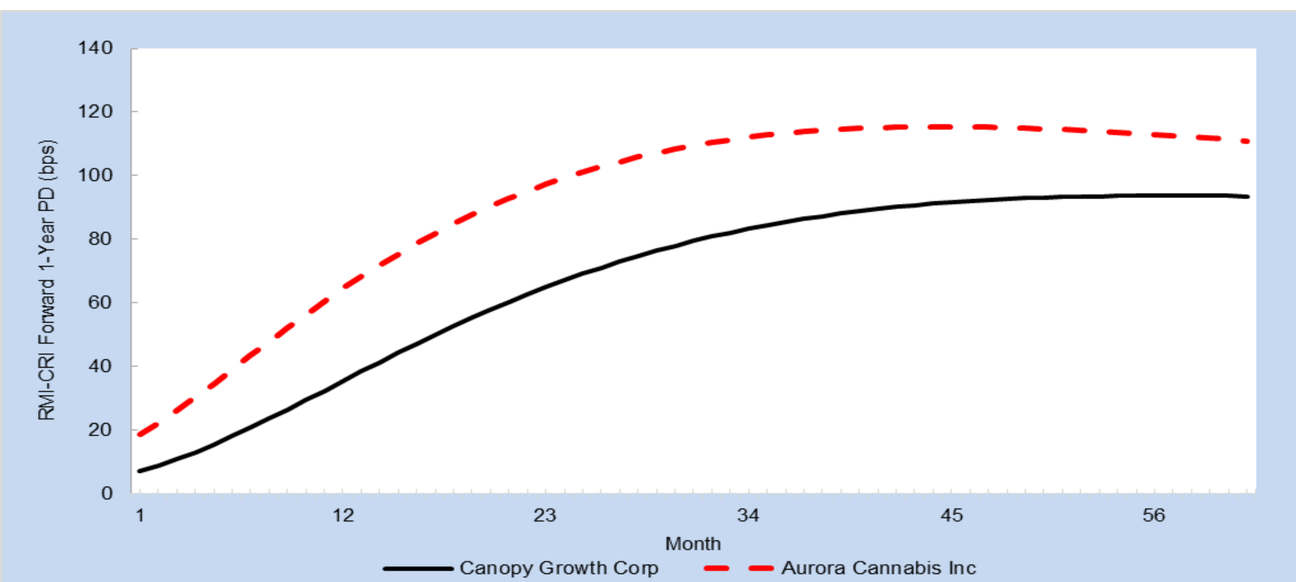

Figure 2: RMI-CRI Forward 1-year PD term structures for Canopy Growth Corp and Aurora Cannabis Inc on October 5, 2018. *Source: RMI-CRI*

While the future looks bright for the marijuana producers in Canada, there are some cautionary measures that they need to consider. For starters, the regulation for marijuana is evolving, making producers hard to comply. Ontario, which accounted for more than 40% of cannabis sales in Canada, planned to limit federally licensed producers such as Canopy and Aurora to one retail location each in their own production facilities, restricting their reach to consumers. Furthermore, the acquisitions and collaborations that they recently embarked on might not be successful. Finally, despite the optimistic forecast, Canopy and Aurora need to proceed with caution especially given their recent increased debt.

Credit News

China slashes banks' reserve requirements as trade war imperils growth

Oct 8. China's central bank announced a 100 basis points cut on banks' reserve requirement ratios in their effort to lower financing costs and drive growth amid concerns over the economic drag caused by the trade war with the United States. This cut matches a similar-sized move back in April. The central bank said that it would continue to take necessary actions to stabilize market expectations while maintaining a prudent and neutral monetary policy. This year, Beijing has stepped up its liquidity support across the financial system as the government aim to calm the fears of capital outflows amid the growing anxiety over the heated trade war with the US. It is estimated that the move by the central bank will inject a net CNY 750bn in cash into the banking system. (Business Times)

Brexit risks take their toll on Britain's high-yield bond market

Oct 3. Speculative-grade rated U.K. companies are avoiding to issue sterling bonds, since headline risks around Brexit are driving borrowing cost higher and market liquidity lower. Sterling bond sales have dropped by nearly 60% this year and the Bloomberg Barclays Index has lost its market value by 18%, indicating a further shrinking market. The tougher market conditions for bonds has helped fuel supply in other asset classes. Some issuers turned to leveraged loan for better terms and the diversified buyer base. Institutional loans up to GBP 6.69bn has been launched to date and it is close to the full year total for 2017. (Bloomberg)

Singapore Q3 bond market stuns with quadrupling of issue value

Oct 3. The Singapore dollar bond issuance quadrupled to SGD 8.8bn in Q3 2018 from Q2. The three Singapore banks issued perpetuals which were snapped up by investors. Government entities such as HDB and the LTA also continued to tap the market as the Singapore government plans to raise debt for infrastructure development. Of the 31 SGD deals done in the third quarter, 40% of these deals were from foreign issuers who took advantage of the favorable SGD swap rates as compared to their own currencies. Analysts are expecting the market for infrastructure and Environmental Social and Governance-linked (ESG-linked) bonds to grow as Singapore positions itself to be an infrastructure hub. (Business Times)

GE downgrade hits company in a debt market it once ruled

Oct 3. General Electric Co. (GE) suffers from a rating downgrade as credit rating agency S&P Global Ratings cut GE's short term grade to A-2, a level below the top tier, while Moody's Investors Service said that it may also cut the company's short-term ratings. Given its current rating, GE may have to pay higher rates to sell its commercial paper, which has been GE's main source of funding for its daily operations. The increase in borrowing cost would add more pressure to GE, which is already facing problems such as slowing demand for its gas turbines, weakening cash flows and probes from the US Securities and Exchange Commission. (Bloomberg)

Comcast clinches one of biggest ever bond issues for Sky deal

Oct 3. Comcast clinches the fourth largest corporate bond sale on record to fund its acquisition of pan-European broadcaster, Sky. The surge of orders for the bond which is driven by investors' appetite for high-quality corporate debt led Comcast to increase its bond sale by USD 7bn, to a total of USD 27bn. The sale comes as overall bond issuance slowed from 2017, which was a record high debt offerings by US companies at USD 4.3tn. Due to the flood of borrowing in the bond market, the overall credit quality of the US corporate bond market has deteriorated and the deterioration has increased the relative attractiveness of Comcast debt, which is rated A-minus by credit rating agencies S&P and Moody's. (FT)

Japan to order Suruga Bank to halt new property loans after scandal: sources (Business Times)

Credit Suisse defends loans to indebted companies (FT)

Greek bank shares slide on bad debt worries (FT)

Regulatory Updates

Ratings firms face reform pressure after failing to flag IL&FS woes

Oct 4. Failing to proactively flag financial problems at IL&FS, rating agencies in India are facing examination of their rating process, standards and methodologies from the Securities and Exchange Board of India (SEBI). The top three rating agencies in India, ICRA - majority owned by Moody's, India Ratings & Research - owned by Fitch, and CARE Ratings had granted IL&FS AAA rating when its subsidiary defaulted in June. Meanwhile, investors expressed their worries as this has happened before in India and the regulator had already tightened disclosure norms for rating agencies to boost transparency and accountability. It also stopped cross-holdings between agencies to prevent conflicts of interest. The lack of confidence in credit ratings may undermine India's financial stability and dry up credit lines. (Economic Times)

Fed rethinks how to define a big bank

Oct 2. The Federal Reserve is developing new rules that would change how a big bank is being defined and thus potentially lower regulatory costs for other financial institutions. The Fed is planning to revise asset size and other thresholds in its capital and liquidity rules such as the liquidity-coverage ratio and regulations that limit banks' borrowing. Some large US banks such as Capital One Financial Corp and US Bancorp may face lower regulatory costs. These rules are part of the Trump administration's move to revamp bank regulations which include the proposed rewrite of Volcker rule's trading restrictions and to change a big-bank capital rule, the leverage ratio. (WSJ)

Bahrain introduces bankruptcy law in legal reform push (Arab News)

ECB supervisor sees no room for lowering capital demand on banks (Reuters)

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