Ninepoint Alternative Health Fund

October 2018 Commentary

Investment Team

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It was the best of times, it was the worst of times...

Investors in the Canadian legal marijuana sector were excited as the month began, eagerly anticipating October 17th, the day when the country would legalize adult recreational use of marijuana. As part of the new cannabis legislation, hemp was also legalized, allowing for the development and cultivation of alternative sources of CBD oil (purported to have a myriad of health and wellness benefits).

There have been months of news reports promoting new stores with unique inventory featuring products that Canadians have only been able to access through the illicit market. However as the day arrived, recreational purchasers reflected with disappointment at the lack of physical stores and a lack of inventory. It was evident that week one did not satisfy legal customers, contributing to the weakening of the Canadian cannabis equity market. However, the weakness in the cannabis sector also partially reflected weakness in the broader market. Results in the cannabis sector were similar to broad market returns as larger economic forces contributed to a market selloff.

In fact, October witnessed North American equity pressures that affected all sectors. During the month, the S&P 500 was -6.9%, the DOW ended -4.9%, and the TSX Composite was -6.3%. The sectors within the Alternative Health Fund also saw reduced results as the Thomson Reuters Canadian Pharmaceuticals Index generated -18.6%, while the North American Marijuana Index (MJIC) returned -23.6%.

Ninepoint Alternative Health Fund is often compared to the passive marijuana ETF listed on the TSX, and during the month, the ETF was -23.7%. We are pleased that for the month, our Fund experienced less than half the downside that the passive ETF witnessed; Alternative Health was -9.38%. Year to Date to October end, the Fund has generated a return of 30.4% relative to the ETF that is -1.9%. Outperformance comes from our ability to take profits proactively; occasionally allocating to cash; writing puts on names that we would like to own but feel prices are above where we see value, in addition to having a broader portfolio allocation that can add growth while reducing volatility. It is in months like this that we remind investors that in a new sector where research is not widely distributed, and the issuance of equity is led by a few boutique firms, active management is important to protect your investment capital.

October 17th was a landmark day for Canada, however the first two weeks of the legal market have been met with less than enthusiastic reviews from consumers. Despite strong demand, operational challenges facing provincial distribution networks have impeded sales.

• The Ontario Cannabis Store (OCS) online retail platform experienced fulfillment delays with many first-day customers unable to receive shipping confirmations more than a week after order placement.

• The OCS site has to deal more effectively with re-stocking issues that as of month end had only ~30% of potential products available.

• In Quebec, the Societe Quebecoise du Cannabis' (SQDC) locations have also experienced inventory shortages in this initial rollout period.

• The SQDC, in an effort to allow itself to add inventory, announced that its physical stores would be closed Mondays to Wednesdays until further notice.

• Alberta was more prepared for the legal market with a stronger inventory position and 17 private retail locations operational on October 17, 2018.

• Our team visited several dispensaries in Alberta in early November, and although store layout was pleasing to customers and offered solid customer service and knowledgeable support, there are significant supply shortages

• British Columbia launched with just one physical store in addition to its online platform

Despite the lacklustre opening of the legal adult usage market in Canada, there were many milestones and announcements that speak to the long term investment opportunity we see in the global medical cannabis market. Canadians were relieved to read that US Customs & Border Services clarified its stance with respect to Canadians working in the legal cannabis industry in Canada that as long as they are not entering the United States to work in the cannabis market, they will be allowed to enter. Former prime minister Brian Mulroney announced that he was joining the board of Acreage Holdings (private), a New York-based marijuana company that also counts former U.S. Speaker of the House John Boehner and former Massachusetts governor William Weld among its directors. These high profile board members are another marker that illustrate the reduced stigma and increased mainstream investment interest of the sector.

There has been increasing focus on large Canadian LP's that have obtained dual listings on US exchanges. The goal is to attract the larger American investor base to this new sector. On October 23rd, during the market selloff, Aurora Cannabis (ACB) began trading on the New York Stock Exchange (NYSE), however it was not met by friendly market participants. Investors have assumed that a US listing will help all Canadian issuers as they look for a dual-listing. However the more liquid and volatile US traders can be challenging, opening equities to aggressive short sellers and other strategies that are not as prevalent north of the border. We note that during the month, the four dual-listed Canadian LP's all witnessed significant selling pressure, in many cases more than the average declines felt on Canadian exchanges. US listings which are on the horizon for select Canadian companies should be treated carefully as they can be a double edged sword, offering significant upside with a voracious appetite for cannabis companies on the major exchanges, while also opening companies up to aggressive trading strategies that may have negative effects. The last week of the month saw Aphria (APHA) announce that it would commence trading on the NYSE, and subsequent to month end began trading on November 2nd.

In International expansion news, one of the Fund's Top Ten holdings, CannTrust Holdings Inc. (TRST) announced that it had entered into a strategic partnership with Cannatrek Ltd. one of Australia's integrated cannabis companies. CannaTrek is focussed on cannabis research, while cultivating out of a 1.7 million sq. ft. greenhouse facility. The goal of the partnership is to offer TRST operational efficiency and scale in order to position Cannatrek as one of the lowest cost producers in Australia.

During the month, the first US public company to public company cannabis sector merger was announced with iAnthus (IAN) and MPX Bioceutical Corporation (MPX) stating that the companies will merge in an all-stock transaction. The Agreement provides that MPX shareholders will receive a premium of 30.6% based on the closing price of iAnthus and MPX common shares on October 17, 2018. The combined company will have licenses in 10 states that will allow a total of 56 retail locations and 14 cultivation facilities. Going forward the company will operate in Arizona, Maryland, Nevada, California.
New York, Florida, Massachusetts, Vermont, Colorado, and New Mexico. With licenses in 10 states, IAN is growing to a scale similar to other leading U.S. multi-state operators such as Green Thumb Industries (GTII), Curaleaf (CURA), Columbia Care (private), MedMen (MMEN) and Harvest (private).

Subsequent to month end, the US mid-term elections produced some significant results that directly impact the North American cannabis industry. The US Democratic Party had a significant victory, picking up 28 seats to gain control of the House of Representatives with 222 seats in total, vs. 199 for the Republican Party. The Republicans however retained control of the US senate, picking up 2 seats to reach 51 total, compared with 46 Senate seats for the Democrats. The change in control of the House to the Democrats for the first time since cannabis liberalization began represents a shift in the US that could lead to a more accommodative cannabis legislation.

In addition to controlling the House, the Democrats also have fewer vocal opponents to cannabis legalization in Congress. Previous House Rules Committee Chairman, Republican Pete Sessions lost his re-election bid in Texas, which is positive for both the national debate as well as a positive step for legalization in the state of Texas. The day after the election, the President accepted the resignation of Attorney General Jeff Sessions, a vocal opponent of cannabis legalization. As Attorney General early this year, he had suggested rescinding The Cole Memo, an Obama Administration document that had been adopted as a policy of non-interference with marijuana-friendly state laws. His statements shifted the debate of federal policy from a hands-off approach to enabling federal prosecutors with enhanced power to crack down on cannabis distribution and cultivation in states where it is legal.

The Democrats control of the House is expected to boost legislation positive for the legal cannabis and hemp industries such as The STATEs Act and The Farm Bill, both pieces of legislation held up due to the mid-term elections. While the political landscape in the U.S. has shifted towards a more supportive stance for cannabis, there are still political challenges. High ranking anti-cannabis Senators such as Ted Cruz (R-TX), Richard Shelby (R-AL), and Mitch McConnell (R-KY) remain in power post-midterms, still posing some challenges to new cannabis reforms at the federal level.

In addition to national elections, there were state initiatives that had positive outcomes, the biggest announcement from the state of Michigan, that approved adult use recreational marijuana and Missouri that approved a new yet limited medical cannabis program. Governors supportive of recreational use legalization were also elected in Illinois and New York, and it is likely that both states start moving towards full legalization.

October had many portfolio companies that announced quarterly results.

A top ten holding in the Fund, Aphria Inc. (APHA) announced its Q1FY19 financial results early in the month. APHA reported that revenues were up 11% QoQ however below expectations on lower than expected average selling prices. Average selling price fell to $7.47 per dried gram equivalent partially reflecting APHA's recent large scale supply agreements with other producers. In addition, cash costs to produce came in at $1.30, higher than the previous quarter's $0.95 as the Aphria One greenhouse experienced staffing shortages which resulted in a significant quarterly crop loss. APHA's adjusted EBITDA came in at -$4 million, below expectations, however we saw solid improvement in controlled SG&A expenses at $14 million, a result that was much lower than many of the leading LP's. APHA is well positioned for the domestic recreational market in addition to expanded global medical opportunities with an increased inventory position of $35million as of August 31st. Important to the long-term growth of the company is that APHA remains on track to complete construction on Part IV and Part V at its Aphria One property. Once licensed in Q418, total output from the Aphria One site will be 100,000 kgs in annual capacity. APHA anticipates licensing in time to complete its first sale from the expansion in January 2019. On the basis of its production expansion, APHA is ahead of many of its Canadian competitors, with near term capacity second only to Canopy Growth (WEED).

Another Top Ten position, Hexo Corp (HEXO) reported Q418 financial results for the three month period and twelve months ended July 31, 2018. HEXO reported an average sales price per equivalent gram of $9.26, among the highest in the industry while its Q4 cash cost of $0.90 per gram places HEXO as one of the lowest-cost producers in Canada. Revenue increased 14% quarter over quarter and the company has cash on the balance sheet of ~$245 million and no debt. HEXO is also adding to its operational capacity, with all 10 zones of its recently completed 250,000 sq. ft. greenhouse having been licensed by Health Canada, which results in HEXO annual capacity reaching ~25,000 kg. With its next phase increase, its one million sq. ft. greenhouse is expected for completion by the end of 2018, with HEXO reaching annual capacity of ~100,000 kg heading into 2019. To help facilitate future growth, the company's acquisition of an interest in a Belleville, Ontario 2 million sq. ft. warehouse facility provides capacity for the manufacturing packaging and distribution of its products.

We believe that HEXO's five-year supply agreement the SAQ, along with its JV with Molson Coors (TAP) position the company well for continued earnings growth and product innovation. We estimate the supply contract over its five year term translates into market share of >30% in the province with cumulative revenues of ~$1 billion. Despite its production growth and its JV with TAP, HEXO trades at ~13.0x 2020 EV/EBITDA, close to the industry average of 12.0x and a significant discount to large-cap LPs at >25.0x.

Part of the success of the Funds' lower volatility performance lies in our wide portfolio allocation that includes large cap global pharma and other healthcare investments. One such investment to highlight is UnitedHealthcare (UNH), a US based health care coverage provider of dental, vision and other insurance plans to meet the needs of individuals, families and groups including Medicare and Medicaid beneficiaries. The company announced its third quarter results on October 15th noting strong top line and bottom line growth. Revenues reached $56.6 billion, up 12% YoY, while earnings from operations grew 12% and adjusted net earnings reached $3.41 Per share increasing 28% YoY.

Options Strategy:
During October, the Fund continued using its option strategy to enhance risk adjusted returns. With the extreme volatility in the options sector, we are able to generate significant option premium, while lowering the overall volatility of the fund. . We are now writing cash secured puts on specific names we would like to own to increase our exposure to such names in the Fund, we are

writing covered calls on names we feel have stretched valuations; and we are writing covered straddles (puts and calls written on the same name but with different strike prices) on names we feel will trade range bound. All three strategies are bullish strategies that allow us to generate option premium or enter positions at more attractive prices during periods of elevated volatility.

During the month of October we wrote puts on core holdings we wanted to further add to, such as CannTrust (TRST and Aphria (APHA), and covered straddles on names such as Canopy Growth (WEED, CGC) and GW Pharma (GWPH) we felt would trade range bound and from which we could receive above average premiums. As a result of the elevated volatility and anxious market sentiment since October 17th we were able to write the options out of the money at strike prices that we believe are closer to values that better represent our belief in the companies.

An example of a very short term weekly trade during the month was a follows:

On October 24th APHA was trading at $15.57 and we wrote a 3 day cash covered put by selling a October 26th expiry at the volatility level of 150 with strike price $15.00 and earning $0.45. That equates to a strike yield of 3% for 3 days outstanding or the equivalent of 329% for a year. The breakeven for being assigned would have been $14.55 or 6.6% lower than the reference point when the trade was placed. On October 26th APHA closed trading out of the money at $15.45 and the put option expired worthless. Our profit was therefore equal to the amount received for selling the put option which was $0.45 per share.

An example of an assigned trade during the month was a follows:

On September 13th HEXO was trading at $8.18 and we wrote a 36 day cash covered put by selling a October 19th expiry at the volatility level of 96 with strike price $8.00 and earning $0.90. That equates to a strike yield of 11.25% for 36 days outstanding or the equivalent of 111% for a year. The breakeven for being assigned would be $7.10 or 13.2% lower than the reference point when the trade was placed. On October 19th HEXO closed trading in the the money at $6.71 and the put option was assigned. Our adjusted cost base of the new HEXO shares assigned were $7.10 vs $8.18 had we not sold covered puts and bought the shares outright. We were thus able to minimize our downside by 12.5% as HEXO retreated during the period the option trade was outstanding. With high volatility in the sector, the Manager continues to believe that option writing can add incremental value going forward.

The Ninepoint Alternative Health Fund, launched in March of 2017 is Canada's first actively managed mutual fund with a focus in the cannabis sector and remains open to new investors, available for purchase on a daily basis. The sector is evolving with new entrants in both the domestic and international markets. Utilizing our actively managed approach we are able to invest when we see new opportunities arise. Temporary market weakness allows the Fund to build a cash position and enter new names that offer attractive valuation opportunities. Many catalysts are on the horizon and we continue to see solid returns for the alternative health space in the coming months and years.

Until next month,

The Alternative Health Fund Team

Compounded Returns[1]

	1 MTH	YTD	3MTH	6MTH	1YR	INCEPTION
FUND	-9.4	30.4	25.4	35.5	69.1	70.6
INDEX	-13.1	13.1	10.2	21.3	52.4	41.8

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at October 31, 2018. The index is 70% Thomson Reuters Canada Health Care Total Return Index and 30% Thomson Reuters United States Healthcare Total Return Index and is computed by Ninepoint Partners LP based on publicly available index information.

The Fund is generally exposed to the following risks. See the prospectus of the Fund for a description of these risks: Cannabis sector risk • Currency risk • Cybersecurity risk • Derivatives risk • Exchange traded fund risk • Foreign investment risk • Inflation risk • Market risk • Regulatory risk • Securities lending, repurchase and reverse repurchase transactions risk • Series risk • Specific issuer risk • Sub-adviser risk • Tax risk

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