Alternative Health Fund

October 2019 Commentary

Investment Team

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Overview

October saw continued headline risk for the US MSO's related to vape pulmonary illness, while Canadian LPs faced new realities related to the challenges of raising capital. There was encouraging news in Canada with month over month sales growth showing continued demand and growing market awareness with overall sales reaching $1.4 billion. Overall, during the month of October, the average for US multi-state operator (MSO) has outperformed the average for Canadian licensed producers LPs by a wide margin, US MSO's down 3% while Cdn LP's down over 12%. The continued lack of storefronts in Canada remains a key challenge for LPs to grow revenue and brand awareness. And despite provinces agreeing to add stores, the process will take months to complete. On the positive side, the market is excited at the prospect of cannabis 2.0 products, but we await the roll out of these new formats, likely to be available for purchase in early in 2020.

Our Fund continues to stand up well in a very challenging market. Our active management, combined with our portfolio allocation and option writing have helped maintain the NAV of the Fund. For the month of October, The Ninepoint Alternative Health Fund was relatively flat at -0.97, relative to HMMJ that posted a -11.95%. Also of note is our year to date performance of -3.45% relative to HMMJ of -23.14%.

Topics Covered:

Regulatory Updates
Company Announcements
Quarterly Financial Results
Options Strategy
Canadian & US Regulatory Updates

US Regulatory Updates:

<u>Catalyst: DOJ M&A Approvals:</u>
During the month, we witnessed the approval of several large M & A transactions by the US Department of Justice's Hart-Scott-Rodino (HSR) Antitrust Review. On Oct 22, it was announced that **Cresco Labs (CL)** and **Origin House (OH)** had been approved after their filing of a second compliance letter to the DOJ. OH is a leading distributor of cannabis brands in California, delivering over 130 branded cannabis products from over 50 brands to the majority of licensed dispensaries across California. The announcement of the transaction passing HSR review mentioned the possibility of deal term adjustments, causing OH to fall after the news. Subsequent to month-end, revised terms for the transaction were announced which benefit CL shareholders, reducing the exchange ratio on the transaction from 0.8428 CL shares for each OH share to 0.7031 CL shares for each OH share. The revised terms represent a reduction of 17% from the original 0.8428 share

exchange ratio and based on the share price performance since the transaction was originally announced in April, the value of the transaction has effectively been reduced from $850 million to $425 million an approximate 50% reduction. Both parties expect the new terms to be approved by shareholders with the transaction in January 2020

CL then announced that its recently announced acquisition of **Tryke** had passed DOJ HSR review. This is the first US cannabis M&A transaction that did not require a “second letter of compliance request”. We view this as positive for future M&A in the sector, which has seen 5 transactions go through HSR to date. CL expects the Tryke transaction will close in the first half of 2020, subject to certain closing conditions including approval from NV, AZ and UT, where Tryke has current operations. We believe this transaction is also instructive as it only took 44 days from transaction announcement to HSR waiting period approval, making it the fastest transaction to make it through the DOJ process. We believe that as more transactions complete the HSR review and ultimately close, it will continue to de-risk the M&A environment among MSOs and potentially cause a re-rating of the leading names in the US MSO space.

Also during the month of October, **Curaleaf (CURA)** stated that its acquisition of **Cura Partners (Select)** business passed the HSR review period and the companies were working toward a closing date of January 1, 2020. CURA also announced that acquisition terms were being adjusted in favour of CURA shareholders, recognizing the change in market prices over the last six months. The newly agreed upon terms, offer a significant discount from the original deal price and enhanced structure by adding incremental performance milestones and reducing the dilution at closing by 42%.

The all-stock purchase of Select previously called for CURA to issue 95.6m shares on closing. Under the amended terms, CURA will now issue 55m shares to Select on closing (current value ~US$300m), with up to another 40.6m shares issuable based on Select reaching certain 2020 revenue targets beginning at $130m and reaching a maximum at $250m in sales. As such, the total share consideration may not change significantly but the new terms serve to better align management of CURA with shareholders of Curaleaf.

In early November, **Harvest Health and Recreation (HARV)** announced that it has filed its second letter of compliance with respect to its proposed acquisition of **Verano**. They now begin the 30 day wait period, which should result in a successful HSR Review around December 4, 2019.

Why are these announcements important catalysts:

We look at these transactions as being positive catalysts for a few reasons. First, with respect to the companies involved, they are adding state operations, brands and distribution to their growing national foot-prints. The approval of the transactions overall is a large catalyst because it shows that federal regulators are not closing down the national foot-prints MSO’s are building. This is a signal to other MSO’s and to investors that the US industry will continue to grow and build bigger stronger companies.

Columbia Care (CCHW) also announced the acquisition of Colorado-based **The Green Solution (TGS-Private)** for total consideration of $140 MM excluding potential earn-outs. Total consideration is comprised of $110 MM in CCHW stock, $15 MM in secured debt and $15 MM in seller’s note. The Company mentioned there is potential for an additional milestone payments in 2021. TGS currently operates 21 dispensaries in Colorado with two additional stores under development expected to open Q4/19. Manufacturing facilities that produce with 250,000 sq ft of indoor cultivation + 16,000 sq ft of greenhouse with combined yield of 48,000 lbs.

As we discuss the SAFE Act and the positive implications on providing access to FDIC Banks, and related services for debt capital targeted at US MSO's, we also see increased activity on the part of specialized REIT's that are providing debt and sale lease back opportunities to various MSO's. This month saw two separate cannabis facility sale leaseback agreements facilitated through NYSE listed Innovative Industrial Properties (IIP) who now have a portfolio of 35 properties across 13 states. Founded in 2016, their focus is to provide real estate capital to the medical use cannabis industry, and have participated with several of our portfolio companies including Trulieve (TRUL), and CL.

Passage of the SAFE Act in the Senate is still legislation that has strong bi-partisan support, however due to impeachment proceedings taking place both in the House and Senate, the Bill may not reach the floor of the Senate by year end. We continue to believe that support for the SAFE Act is still strong, but it appears this important catalyst may have to wait until early 2020 for full Congressional approval.

Canadian Regulatory Update:

The Ontario Cannabis Store (OCS) is reviewing alternatives to distribution under the current provincial system. The OCS has been meeting with Licensed Producers and authorized retail stores involving increased private sector participation, distribution and retail services for the cannabis industry. This comes in the wake of news that in its first year of operations, the OCS lost close to $60 million and continues to have inventory control issues. The OCS in the early stages towards enhanced private retail participation and has already announced plans to allow online customers to review inventory at Ontario dispensaries, buy from inventory available and pick up at stores. We see this as a small positive, giving consumers another purchasing method in addition to the ones currently available. More encouraging for Ontario residents and LP's across the country is that as part of the changes, the Ontario government plans to amend the current legislation to allow LPs to open retail stores near their production facilities. While further clarification is needed on which license holders will be able to set up locations, any incremental store additions is positive. With 40% of the Canadian population residing in Ontario, the painfully slow roll out of stores has significantly impeded sales.

The lack of retail storefronts for Ontario residents remains a major bottleneck for LP product distribution, revenues and cash flows. The increase to 75 stores will provide an incremental increase, yet Ontario still lags other provinces by a wide margin. At 75 stores, this would imply one cannabis retail location per ~195,000 residents in Ontario, versus British Columbia at ~42,000 residents/store and Alberta at ~14,000 residents/store.

Canadian Market Announcements:

Canopy Growth (WEED) and Drake have re-launched "More Life Growth Company". More Life was previously a wholly owned subsidiary of WEED and now Drake and related entities have a 60% ownership interest in More Life, with Canopy retaining 40%. The More Life Growth Company is the owner of a cultivation facility in Scarborough that is licensed by Health Canada acquired by WEED in its Bedrocan acquisition in 2015.

WEED will continue to provide all of the day-to-day operations and maintenance of the More Life Facility and will retain all of the rights to distribute the product that is cultivated there.

Drake has granted More Life Growth Company the right to certain intellectual property and brands in association with the growth, manufacture, production, marketing and sale of cannabis and cannabis-related products, accessories, merchandise and paraphernalia in Canada and internationally. This is a major brand announcement for WEED, capturing one of the world's best known and most successful music brands.

In these early days of legalisation, the race is on to build brand equity/distribution, which is increasingly difficult with more products hitting the market all the time, all competing for the same shelf space (which is currently limited due to inadequate number of retail locations), and restrictions around advertising and packaging. Partnerships with established brands or personalities can help accelerate this process and allow products to stand out, while also targeting new consumers or adding a sense of legitimacy to their brand. The LPs name gets associated with a celebrity and therefore its other brands get an indirect endorsement. In the case of Canopy, as it has its own retail locations, it can see further benefits as consumers may come in to look for the celebrity products, and then the wider Canopy range, also in the store, gets recognition and visibility.

We continue to see value in our Canadian cannabis exposure towards the extraction companies as they are well positioned to be involved in the roll out of new extract products. **Valens GroWorks (VGW)** announced a multi-year white-label agreement with BRNT. Under the terms of the two-year agreement with two successive one year renewal options, VGW is to provide cannabis extracts, filling services and national distribution of a line of BRNT's introductory vape line. With the production and sale of a guaranteed minimum of 2.2 million BRNT-branded vape pens, the gross revenue potential to Valens amounts to $50 million in the first two years. Valens expects the first shipment under the agreement to take place in the first quarter of 2020.

Challenges for Canadian LP's

HEXO has had a challenging few months. It has had to adjust its 2020 guidance dramatically which hurt its market price, while it also announced the resignation of its third CFO within nine months, not a series of announcements a company wants to communicate to equity markets.
HEXO then delayed the release of its Q4/FY19 financial results.

In order to raise capital at a time that its share price had weakened, the company announced a private placement, $70m of 3 yr convertible debentures at a strike price of $3.16, which was ~5% in-the-money at the time of the stock's halting ahead of the financing announcement.

Hexo also announced the termination of 200 employees including several senior positions while closing its 200,000 sq ft indoor grow facility in Niagara that it had recently acquired as part of the Newstrike acquisition. All of these announcements represent a weakened Cdn outlook for cultivators as the combination of lack of dispensaries along with distribution challenges is leading to price compression and excess inventory that could weigh on producers in coming quarters.

Aleafia Health Inc (ALEF) has terminated its cannabis supply agreement with Aphria APH, whereby APH was to provide up to 175,000 kg equivalents of cannabis products over a five year period. This agreement was signed in September 2018 between APH and Emblem Corp. which ALEF has since acquired. This is interesting as APH has enough supply to meet the contract, and might be interested in breaking the contract due to pricing terms that it feels can be better through other sales channels.

Financial Results:

Aphria (APH) reported Q120 results for the period ending August 31. Net Revenue was $126.1 million, decreased 2% QoQ and was 4% below consensus estimates. Net Cannabis Revenue was $30.8 million with an average selling price of $7.56 per gram, relative to the previous quarter that had an avg selling price of $7.66. A significant portion of top line revenue emanates from German pharmaceutical distribution, that decreased 4% QoQ. Adjusted gross margin was 22% below consensus estimates of 28%, while cash cost per gram came in at $1.43/gram and "All in" cost/gram was $2.52 up from the previous quarter at $2.35. Aphria reported adj. EBITDA of +~$1mm, which was better than consensus estimates showing improving cost management, where G&A expenses fell (11%) QoQ. Aphria also reiterated its F2020 guidance of $650-$700mm in net revenue (Cannabis sales representing slightly less than half) and EBITDA of $88-$95mm. The company plans to achieve this guidance with additional production capacity from Aphria Diamond that received Health Canada cultivation license in early November, along with good traction in derivative products as part of its Cannabis 2.0 roll out, cost efficiencies from increased scale, along with continued momentum from key brands. Guidance in our opinion is high, and seems to assume that all aspects of the plan for 2020 fire on all cylinders without skipping a beat. We have seen so often in the cannabis sector that it rarely moves from point to point in a straight line. As a result, while we are less confident in the company reaching its guidance, we still see it achieving solid growth in 2020.

HEXO announced Q4/FY19 revenues that were pre released, coming in at $15.4m, up 18% QoQ with all estimates having been lowered by ~50% following HEXO's reduced guidance in early October. Overall avg. selling prices of ~$3.20/gram were down ~30%, and lower than many of the larger LP's in the country. Q4 EBITDA loss was the largest in the company's history at –$30m, more than double consensus estimate of –$13m. The main driver appears to be a much larger increase in SG&A than expected, which more than doubled QoQ to ~$35m.

Given the challenges faced by many of the Canadian LP's, the Fund continues to be overweight US MSO's during this year. We have stated from the outset of 2019, that we believe the underlying value of US MSO's is not appreciated and continues to trail the valuation metrics of Cdn LP's. However when one looks at the market opportunity, US MSO's have a larger addressable market at approximately 200 million people in 33 states vs 37 million people in Canada. Also important is that US MSO's have greater ability to market their products and build brands both in dispensaries and outside the cannabis dispensaries with the Farm Bill legalizing hemp derived CBD across all 50 states. In addition, the regulatory environment continues to favour increased legalization rather than slowing down the release of cannabis products in all its various formats.

Options:

During October the Fund continued using its option strategy to enhance risk adjusted returns. With the above average volatility in the cannabis and associated health care sectors, we are able to generate significant option premium, while lowering the overall volatility of the Fund relative to its underlying benchmark. Since inception of the option writing program in September 2018, the Fund has generated significant income from option premium of over $2.23 million.

During the month we used our option strategy to assist in rebalancing the portfolio in favor of names we prefer while generating an impressive $134,000 in option income. During the month, we were able to write cash secured puts out of the money at strike prices that offered opportunities to increase our exposure, at more attractive prices, to names already in the Fund including Village Farms (VFF), GW Pharma (GWPH) and United Health (UNH). We continue to write covered calls and strangles on names we feel are range bound near term and from which we could receive above average premiums. Examples of such trades include Canopy Growth (CGC), Planet Fitness (PLNT), Intuitive Surgical (ISRG) and Aphria (APHA), with covered calls on APHA having been especially rewarding. We have been able to take advantage of both the recent price appreciation and elevated volatility to write covered calls on Aphria. Explained below is the summary of a trade on Aphria for the month of October.

Aphria is in our top 25 holdings and we have a near term range bound view on the name. On October 3rd APHA was trading at USD $5.22 and we wrote a 15 day covered call by selling an October 18th expiry at the volatility level of 103% with strike price USD$5.50 and earning USD$0.30. That equates to a strike yield of 5.45% for 15 days outstanding or the equivalent of 139% for a year. The breakeven for being assigned would be USD$5.80 or 11.1% higher than the reference point when the trade was placed. On October 18th APHA ended trading out of the money at USD $4.75 whereby we were able to roll the contract forward and sell additional calls capturing further upside potential. At the price of USD $4.75 investors who continued to hold the name but who had not used the covered call strategy would be down 9.0% since October 3rd whereas with our option income earned we were down 3.55%, an outperformance of 5.45% with the ability to write further calls.

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. Utilizing our actively managed approach we are able to generate industry leading risk adjusted returns.

Charles Taerk & Douglas Waterson

Portfolio Team
Ninepoint Alternative Health Fund

Compounded Returns[1]

	1MTH	3MTH	6MTH	YTD	1YR	INCEPTION
FUND	0.84	-8.37	-20.82	-2.60	-10.49	25.80
INDEX	-3.19	-15.42	-27.82	-6.27	-19.30	9.16

Statistical Analysis

	FUND	INDEX
Cumulative Returns	68.9%	21.61%
Standard Deviation	31.27	33.02
Sharpe Ratio	0.81	0.24

[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, 2019. 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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