Thankfully, we ended 2019 with a solid month. This brought the Dark Horse’s performance back to positive. In a year where most every asset class was up, and up substantially, being fractionally positive is hardly anything to crow about. While the results may have outperformed the interest rate on your chequing account or a bet on the Patriots Super Bowl moneyline, they certainly did not meet our expectations.

While the year was challenging for most people operating in our chosen areas of the market, that does not fully explain, or justify, the underperformance of the Dark Horse in 2019. The Fund had a number of missteps which were compounded by the fact that the portfolio was nearly devoid of any positive catalytic events. Such events, as opposed to broader market moves, are what typically drive the Fund’s overall performance.

In previous years we have had more than our fair share of bad, if not downright stupid trades. Typically, however, these mishaps are obscured by our winners. 2019 was shockingly, and almost unfathomably, winnerless while unfortunately being overly abundant on the poor to mediocre variety. History has shown us that the frequency of these events do tend to normalize and that periods of fewer hits are typically soon followed by a catch up period. December and January are showing signs that this dynamic has begun to play itself out once again.

As the Fund’s new management team, John and I have spent our first few months evaluating the portfolio from both a bottom-up, name-by-name basis, as well as through the lens of a top-down, big picture philosophy. These efforts have not brought about any wholesale changes, though we have amended many position sizes, closed a handful of positions and initiated a few new positions that we are quite excited about.

During a time when massive pools of capital, with their algorithms and narrative-based investing styles, dominate the capital markets, the situations that we tend to gravitate towards will be even more plentiful and ultimately even more profitable. Given this dynamic, it is our belief, that the Dark Horse, under the guise of investing where others can’t or won’t, continues to occupy a very important niche in the Canadian capital markets, and amongst the Ewing Morris product suite.

Going back to the earlier point about how specific winners tend to drive our results, let’s turn our attention to one of our new holdings – one that, we are confident, will become one of the success stories in 2020.
LONG Alcanna Inc.: I’m either on something or I’m onto something

Our most recently initiated long position may have a familiar sounding name, but it’s probably not the company you’re thinking of. Alcanna is the name a bunch of consultants were paid to come up with when the company formerly known as Liquor Stores Income Fund wanted to hitch its wagon to the red-hot cannabis trade of 2018. We can only assume Weedy McPotface was taken.

In order to find out how this company ended up on our radar, and eventually in the portfolio, we’ll need to run you through a bit of a primer. If you want to skip all that and get right to the conclusion, here it is – this is a cheap stock in a sneakily well-run business with the potential for a really silly narrative to drive the stock way higher than it ever should be. Damnit, probably should have kept that to the end. I knew I’d be a bit rusty at this.

You know that guy who, at the beginning of the night, really gets the party started? He’s all energy – turning up the music, filling the drinks. He’s the best, and everyone is glad he’s at the party...at least at the beginning. After a few hours of partying, now he’s inexplicably got his shirt off. He’s yelling “Shots! Shots! Shots!” He’s picking people up over his head, and dear God, he’s doing Borat impressions. Someone needs to let this dude know that it’s Wednesday and this is my daughter’s birthday party.

For this Alcanna story, that guy is Aurora Cannabis (ACB:TSX), one of the most prominent Canadian LPs\(^1\). Aurora, seemingly having pre-gamed somewhere else, got this party started by agreeing to take a 25% stake in Alcanna (then still known as Liquor Stores) at $15 per share. That was back in February 2018 and some 7 months before weed was nationally legalized in Canada. Aurora’s stock was trading a gram or two below $10 on its way to a peak of $13.71 a share, and a market capitalization of around $12 billion\(^2\)! A few months later, Aurora’s investment was followed up with an announcement that the two companies would further their relationship by opening Aurora branded cannabis stores. The market and the 238 Canadian brokerage firms that had launched coverage of the cannabis space cheered the combination. Everyone loved having Aurora at the Alcanna party!

Oh, how times have changed. We are now in the “someone should get this guy an Uber” phase of Aurora’s involvement with Alcanna. Aurora’s stock has been decimated, having plunged 85% to nearly $2 and they are now facing a legitimate risk of going broke. They have listed greenhouses for sale and heavily diluted shareholders with a recent convertible debt equitization. The company’s perilous financial condition has led to speculation that Aurora will blow out its stake in Alcanna as it looks to avoid bankruptcy. Widespread belief that a quarter of your, relatively illiquid, company is going to be liquidated by a desperate seller is not a great set up for stellar stock price performance.

Aurora’s imprimatur has clearly shifted to a contagion for Alcanna’s stock price. This was seen most acutely in the days following Alcanna’s last quarterly release. The quarter was undeniably a good quarter

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\(^1\) An LP is a Licensed Producer of cannabis.

\(^2\) On a trailing basis, this was justified by a similar amount of sales as the guy you bought weed from back in school, albeit without his profitability.
with comp store sales\(^3\), total sales and gross margin all coming in ahead of expectations, leading to overwhelming praise from the analyst community. After an immediate pop, Alcanna’s shares inexplicably began to tumble.

The excitement over the company’s actual operating results was quickly obscured as rumours regarding the actions of its troubled shareholder started circulating. In this “up and to the right” market we’re familiar with the bad-news-equals-good-news scenario, but good news rarely equals bad news. Bad news, that is, for existing shareholders who saw the stock crater.

Enter the Dark Horse. We have recently acquired a stake in Alcanna in the low $4s, approximately 75% less than Aurora paid for its stake. Clearly, the possibility of a forced seller has weighed heavily on Alcanna’s stock price. The question remains, is it a business worth owning at these prices? Our belief is a most definite yes!

Interestingly, Aurora’s presence never really had any impact, good or bad, on the actual underlying business. Alcanna is, after all, a liquor retailer with approximately 90% of its sales, and essentially all of its EBITDA, coming from its core business – which its old boring name made much more obvious – of selling booze.

The second half of the old boring name, Income Fund, indicates that the company was previously an income trust. Granted, not all income trusts had the requisite consistent cash flow characteristics to pay the hefty dividends that came with that structure. The old Alcanna, however, was actually a pretty decent representative of a business that fit that mould. People tend to buy booze frequently, sometimes they buy a bit more and sometimes they buy a bit less. If there was ever a retail business that could conceivably support the consistent yield needs of an income trust, liquor stores would be that business.

At its core, liquor retailing is a business that, apart from periods of extreme competition (or perhaps regulatory change), should be relatively simple to handicap. That is what we seek in managing the Dark Horse – we look to acquire cheap assets and/or cash flow streams that we can model with some degree of certainty, that are being obscured by something intangible. When you think about it, is there a better distillation of that mantra than a portfolio of liquor stores being masked by the fact that the largest shareholder is a desperate weed company looking to stave off bankruptcy?

Alcanna has had its share of operational struggles over the past couple of years, though not to the extent one would imagine by seeing a stock price plunge from $15 to $4. A prolonged period of under-investment – a staple of most former income trusts – resulted in a tired store base leaving the company vulnerable to discount competition. Instead of focussing on its core Alberta market, management paid up to enter unrelated markets with a seemingly growth for growth’s sake M&A strategy. What remained was a cash-strapped business that lacked focus or direction.

\(^3\) Comp store sales is a measure of sales growth on like-for-like stores that have been open for more than a year. It is a heavily relied upon metric to evaluate organic sales growth and the overall health of retailers.
These actions (or inactions) not only opened the company up to competitive threats but also left the company vulnerable to activist pressure. In 2017, the Board and management were replaced, as the company surrendered to a PointNorth-led activist campaign. Under new management and board leadership, the company set about to right the wrongs of previous mismanagement.

The new regime’s biggest win was convincing Aurora to invest more than $100 million in newly issued stock. This was early 2018, which is a bit like when your parents say things like “it was the 70s” in justifying their terribly irresponsible decisions. Alcanna adroitly used this money to successfully re-invest in the Alberta store base, buy up a nuisance competitor, and acquire stores from another competitor that had gone out of business. The newly bulked-up balance sheet was also used to invest in its own aggressive pricing that crippled what was left of its discount competition. In addition, management divested the non-core New Jersey and Kentucky businesses. By the time Aurora realized it had way overpaid for the stock (“Bro, I think this is just oregano”), Alcanna was well on its way to re-emerging as a focused and dominant player in Alberta liquor retailing.

The company will soon report its fourth quarter results which will be the first since the competition in Alberta has been fully rationalized (both in size and behaviour). It is our expectation that we will see a meaningful acceleration in operating leverage as the Alberta liquor market returns to more reasonable pricing. Alcanna should be able to hold onto its reclaimed market share and do so at margins that more closely reflect those that they once enjoyed. This core business has a normalized earnings power in the range of $40 million on current revenue. Using a range of reasonable multiples, we see this as translating into an equity value of between $5.50-$6.50 per share, some 35%-60% higher than the current price.

It is our belief that as the recovery in the core business becomes evident, the substantial value in this business will be nearly impossible to ignore. Certainly, for the stock to entirely reflect its true underlying value something will have to be done about the Aurora overhang. Until this Bong of Damocles has been lifted, either with Aurora getting its financial house in order, or (more likely) getting that block into more stable hands, Alcanna’s stock price will be under some pressure. While Aurora’s public stance has been that it does not want to, and does not have to, sell its stake, it would be clearly best for everyone if it moved on and did so in an orderly fashion. We feel confident, however, that Aurora’s finances are not so dire that they will try to force out its stock on the open market and that this situation will be resolved in relatively short order.

So why was Aurora ever part of this story? What is the weed angle here? The short answer is that despite shoehorning “canna” into its name, Alcanna is not a weed story; at least not one you are paying for at current prices. While the company operates a handful of cannabis stores (approaching 30 stores in Alberta, and an announced plan to go from 1 to 10 stores in Ontario) the valuation is more than backstopped by the substantially more relevant booze business.

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4 The company maintains a small operation in Alaska, which is likely soon to be divested now that its operations have been stabilized. Apparently with Alaska, Kentucky and New Jersey previous management felt it best to operate in three states that were as far apart as possible while also having the least in common with each other. Mission accomplished.
Perhaps I should start the next part of the story by making one point abundantly clear. In my opinion, most everything about the weed trade is dumb. The valuations are dumb, many of the business models are dumb, a bunch of the dodgy promoters associated with these companies are dumb. It is all just so dumb. The amount of weed that every man, woman and child would have to smoke to justify the peak total market cap of publicly listed Canadian weed stocks is staggering. We would all have to be tremendously, and permanently, high. Not normal high either, we’re talking so high you don’t hate Dave Matthews-level high. That may be an exaggeration. It’s probably not possible to be that high.

That doesn’t mean, however, that there isn’t at least the potential for this part of Alcanna’s business to be worth something. As ridiculous as most of the hype around the weed industry is turning out to be, there will be someone making money legally selling pot in Canada. Alcanna, with its stellar balance sheet, established landlord relationships and retailing acumen is better suited than most anyone else, particularly anyone publicly traded, to turn cannabis retailing into a legitimate, and sustainably profitable, business.

Alcanna is already turning a small profit in the space (albeit the amounts may not be significant depending upon share service and head office allocations) and will be adding outlets when, and only when, it finds the right real estate at the right price. What exactly that will be worth is not something we would have any great ability to predict. That being said, we are quite confident it is in excess of the current negative value the market seems to be ascribing to it and would be accretive to our estimates of what the overall business is worth.

What is most exciting from a tangible returns point of view, above and beyond just a re-rating towards our current estimate of intrinsic value, is the potential for liquor retailing in Ontario. This opportunity is one that could have a far more immediate and substantial impact on shareholder returns than news of more pot store openings\(^5\). We think Alcanna’s Wine and Beyond\(^6\) banner of stores would absolutely clean up in an Ontario market opened to private competition, particularly in the early years of privatization. Even in advance of a legislative change, the hype associated with a newly-opened market could see a repeat of the enthusiasm seen during the heyday of the weed bubble.

We are not saying that the Ford government will privatize liquor sales in Ontario, only that there is a meaningful chance that it could happen. Just like the cannabis retailing optionality within Alcanna, this is an area of upside that comes for free when you can acquire the stock at such heavily discounted prices.

\(^5\) This may also be bias given your author’s preference for craft beer while his most notable weed experience was an afternoon in high school spent freaking out in the back seat of his buddy’s car. Ironically that car was parked outside his alma mater, (and we kid you not) Aurora High.

\(^6\) If any of you have enjoyed a Total Wine store in Florida, Arizona or any of the other states they operate in you’ll be familiar with the Wine and Beyond concept.
Alcanna is a wonderful example of what we strive to populate the Dark Horse with – good assets hidden by something intangible, ideally in a situation where prudent management and directors are already in place working for shareholders. On top of that there is an upside scenario whereby the stock could eventually trade at a multiple of where we acquired it. These criteria have defined our ideal long candidates since the Fund was launched more than a decade ago. The present dislocation in Canadian small cap equities is presenting us numerous opportunities like this where our patience and willingness to look beyond the headlines should allow us to start filling up the win column once again.

Sincerely,

Anthony Hammill

John Ewing
About Ewing Morris:

Ewing Morris & Co. Investment Partners Ltd. is a value driven Canadian investment firm established in September 2011 by John Ewing and Darcy Morris. Our aim is to achieve preservation and growth of capital for our limited partners by focusing on inefficient markets. We do this by relying on fundamental analysis, high conviction and the use of flexible capital. We manage equity and credit strategies with a focus on North American small-capitalization companies and high yield bonds. We manage investments for individuals as well as charitable organizations, institutions and corporations.

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