

Emblem Corp.^{1,7}

BUY

EMC-TSXV

December 20, 2018

 Last: **C\$1.00**
 ▼ Target: **C\$2.00**

Aleafia's acquisition price appears too low

Emblem announced yesterday a definitive agreement with Aleafia Health Inc. (ALEF-TSXV), where Aleafia will acquire all the outstanding shares of Emblem for a total transaction value of \$173m. This friendly transaction is an all-stock deal in which Aleafia will issue 0.8377 shares for each share of Emblem, representing a purchase price of \$1.21, a premium of 27% to Emblem's closing price of \$0.95. A shareholder meeting will occur before March 8, 2019 to vote on the transaction.

Purchase price appears to undervalue Emblem. The price of \$1.21 is low, in our view, for the following reasons: (1) the EV/forward sales multiple of ~1.5x is lower than average multiple of 3-5x forward sales seen in the sector; (2) the takeout price represent a ~5% premium to EMC's 30-day VWAP, which is lower than the usual ~30% premium; and (3) EMC does not have operational or financial issues which could have weakened its bargaining power, but rather a bright outlook.

Surprising outcome. While we acknowledge that large LPs benefit from a substantial valuation premium to peers, we are not convinced that a combination with Aleafia will help to narrow that gap. Further, we struggle to see what Aleafia brings to the table that Emblem was missing. While there will be synergies in combining both companies, they have not been quantified. Hence, we are puzzled by the decision of Emblem's BOD to choose the Aleafia takeover as the best alternative given that it could have achieved similar results on its own.

Could Emblem have been successful on its own? We consider that EMC has a bright outlook due to: (1) its solid endorsement from Shoppers which selected EMC as a preferred supplier; (2) its significant sourcing agreement with Aphria at what we believe are very attractive prices, reducing operational risk; (3) its wide reach in the recreational market with products distributed in four provinces; and (4) promising innovations such as the oral spray and sustained released tablets.

Valuation and recommendation

Maintaining our BUY rating and decreasing our target by \$0.75 to \$2.00. We are reducing our target price using a higher discount rate to reflect the company's smaller size and recent cannabis sector re-rating. However, we are leaving our rating at BUY as opposed to TENDER to reflect our view that Aleafia's offer price is too low. While we have limited visibility on shareholder support aside from commitments of 12% of shares from Emblem's management team and BOD, we believe that support will be mixed. In addition, given Emblem's low valuation, trading at 6x 2019 EBITDA, other potential bidders may take a look. Our target is based on a DCF using: 1) an 11.5% discount rate (10.5% previously), 2) 4.25% average share of the Canadian recreational market, 3) average EBITDA margin of 20% (22% previously), and 4) a terminal growth rate of 3%.

What's Changed	Old	New
Rating	BUY	n.c.
Target	\$2.75	\$2.00
Revenue 2018E (mm)	\$8.3	n.c.
Revenue 2019E (mm)	\$86.8	n.c.
Revenue 2020E (mm)	\$139.3	n.c.
EBITDA 2018E	(\$11.7)	n.c.
EBITDA 2019E	\$16.7	n.c.
EBITDA 2020E	\$32.3	n.c.

Share Data

Share o/s (mm, basic/f.d.)	123.6 / 138.7
52-week high/low	2.76 / 0.83
Market cap (basic, mm)	\$124
Market cap (f.d., mm)	\$139
Net cash (mm)	\$32
Net cash (f.d., mm)	\$44
EV (f.d., mm)	\$95
Projected return	100.0%

Financial Data

FYE Dec 31	2018E	2019E	2020E
Revenue (mm)	\$8.3	\$86.8	\$139.3
EBITDA (mm)	(\$11.7)	\$16.7	\$32.3
EV/EBITDA	nmf	5.7x	2.9x
EPS (f.d.)	-\$0.17	\$0.09	\$0.20
P/E	nmf	10.6x	5.0x
CFPS	-\$0.30	-\$0.07	\$0.04
P/CF	nmf	nmf	nmf
Net cash (mm)	\$46.9	\$31.8	\$34.6
BVPS	\$0.69	\$0.76	\$0.97
P/BV	1.5x	1.3x	1.0x

All figures in C\$ unless otherwise noted

 Current Chart

 Previous Research

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CORPORATE UPDATE December 19, 2018

EMBLEM CORP.
(V-EMC) \$1.03 (Intraday)

RATING: TENDER
(previously BUY)

TARGET: N/A
(previously \$3.50)

Aleafia to Acquire Emblem

- ▶ **EVENT:** Aleafia Health (V-ALEF) and Emblem have entered into a definitive agreement for ALEF to acquire all the issued and outstanding common shares of EMC.
- ▶ **DISCUSSION:** The transaction is an all-share transaction valued at approximately \$173.2M (equivalent to \$1.21/share of EMC), whereby each EMC share will be exchanged for 0.8377 shares of ALEF. This represent a 27% premium based on the closing prices of Aleafia and Emblem shares on December 18th. Post-merger, existing ALEF shareholders will own 59% of the combined entity and EMC shareholders will own the remaining 41% on a fully diluted basis.
- ▶ The combined entity will have Canada's largest cannabis clinic network with access to 40 national medical clinics and education centres that have served almost 60,000 patients and will have planned annual capacity of 138,000kg in 2019 (including current supply agreements).
- ▶ Together ALEF and EMC will have nationwide and global distribution channels including provincial supply agreements (AB, BC, ON, SK), national medical distribution (Shoppers Drug Mart), national retail distribution (Fire & Flower, Starbuds and OnePlant Network), Germany medical distribution (through EMC's JV with Acnos Pharma) and Australia medical distribution (pending completion of ALEF's transaction with CannaPacific).
- ▶ ALEF and EMC currently have access to a combined \$70M in cash which allows the combined entity to utilize the cash for product innovation and brand building, construction and development of cultivation facilities and outdoor grow facility, footprint expansion efforts and strategic investments.
- ▶ EMC shareholder support must exceed 66 2/3% in order for the transaction to go through. We expect the shareholder vote to pass and we anticipate the final closing date on this transaction will be in January or February.
- ▶ **IMPACT: Positive.** The acquisition of Emblem by Aleafia will create an entity with improved scale and expanded distribution channels. The offer price is lower than we expected so there remains a chance for a competing offer but we do recognize that the sector has been in a declining market since its peak in mid-October. We expect continued consolidation in the sector, specifically with small to medium sized LP's in an attempt to scale up and gain additional market share.
- ▶ **FORECAST/OUTLOOK:** Our revenue forecasts for FY18, FY19 and FY20 are \$8.3M, \$61.4M and \$145.1M (unchanged). Our EBITDA forecasts for the same period are (\$9.8M), \$5.5M and \$40.0M (unchanged).
- ▶ **VALUATION/RECOMMENDATION:** We are changing our rating to **TENDER** (risk: **SPECULATIVE**) for Emblem Corp. (V-EMC).

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Company Statistics

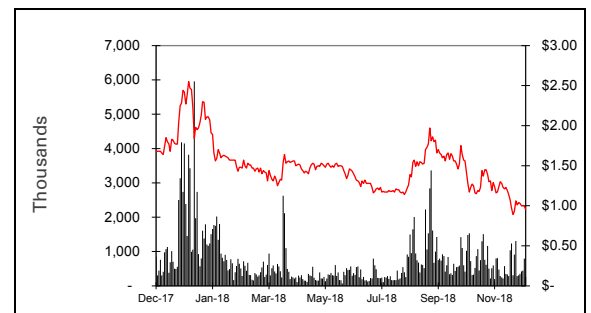
Risk:	SPECULATIVE
52-week High/Low:	\$2.76 / \$0.83
Shares o/s ('000):	123,606
Shares o/s (fd) ('000):	190,023
Market Cap (fd) ('000):	\$195,724
Cash ('000):	\$46,608
Debt ('000):	\$24,568
CEO:	Nick Dean
CFO:	Alex Stojanovic
Shareholders:	Mgmt/Insider 4% Institutional 3%

Financial Summary

(YE Dec 31)

\$CAD	FY17a	FY18e	FY19e	FY20e
Revenue (\$K)	2,694	8,253	61,411	145,108
EBITDA (\$K)	(8,729)	(9,795)	5,483	39,912
EBITDA (%)	-324.0%	-118.7%	8.9%	27.5%
Net income (\$K)	(12,101)	(21,373)	795	27,230
EPS (\$)	(0.14)	(0.16)	0.00	0.14
EV/EBITDA	na	na	19.2x	2.6x
P/E	na	na	246.2x	7.2x

Quarterly EPS (\$)	Q1	Q2	Q3	Q4
FY17	(0.04)a	(0.03)a	(0.03)a	(0.04)a
FY18	(0.03)a	(0.04)a	(0.09)a	(0.01)e



Corporate Information

Emblem Corp. is a fully integrated Canadian medical marijuana, healthcare and cannabinoid-based pharmaceutical company. Emblem has production facilities in Paris, Ontario.

A Disclosure fact sheet is available on Pages 2-3 of this report.

Disclosure Fact Sheet

Ratings

BUY : recommendation: stock is expected to appreciate from its current price level at least 10-20% in the next 12 months.

NEUTRAL : recommendation: stock is expected to trade in a narrow range from its current price level in the next 12 months.

SELL : recommendation: stock is expected to decline from its current price level at least 10-20% in the next 12 months.

U/R : Under Review

N/R : No Rating

TENDER: Investors are guided to tender to the terms of the takeover offer.

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Price Volatility / Risk

SPECULATIVE : The Company has no established operating revenue, and/or balance sheet or cash flow concerns exist. Typically low public float or lack of liquidity exists. Rated for risk tolerant investors only.

ABOVE AVERAGE : Revenue and earnings predictability may not be established. Balance sheet or cash flow concerns may exist. Stock may exhibit low liquidity.

AVERAGE : Average revenue and earnings predictability has been established; no significant cash flow/balance sheet concerns are foreseeable over the next 12 months. Reasonable liquidity exists. Price Volatility/Risk analysis while broad based includes the risks associated with a company's balance sheet, variability of revenue or earnings, industry or sector risks, and liquidity risk.

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The attached summarizes PI’s analysts review of the material operations of the attached company(s).

Analyst	Company	Type of Review	Operations / Project	Date
Jason Zandberg	Emblem Corp.	Company Call	Vancouver, BC	12/18
Jason Zandberg	Emblem Corp.	Site visit	Paris, Ontario	05/18

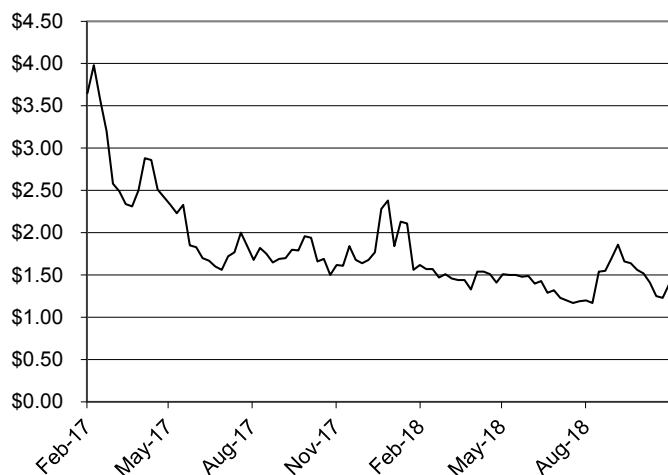
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Recommendations	Number of Recommendations	Percentage
BUY	69	90.79%
NEUTRAL	4	5.26%
SELL	0	0.00%
TENDER	1	3.95%
U/R	2	0.00%
N/R	0	0.00%
TOTAL	76	

Stock Rating and Target Changes

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Emblem Corp. (Initiated Coverage: Dec 08/16)

Date	Rating Change	Target Change	Share Price
Dec 19/18	Buy to Tender	\$3.50 to N/A	\$1.03*
Nov 20/18	Buy	\$3.00 to \$3.50	\$1.18
Aug 22/18	Buy	\$2.75 to \$3.00	\$1.39
Apr 27/18	Neutral to Buy	\$2.00 to \$2.75	\$1.51*
Nov 29/17	Buy to Neutral	\$3.00 to \$2.00	\$1.80
Aug 29/17	Buy	\$3.75 to \$3.00	\$1.77
May 2/17	Buy	\$4.15 to \$3.75	\$2.56*
Apr 13/17	Buy	\$3.75 to \$4.15	\$3.03
Feb 27/17	Buy	\$3.50 to \$3.75	\$3.57*
Dec 13/16	Buy	\$3.25 to \$3.50	\$3.19*
Dec 08/16	Buy	\$3.25	\$1.15

*Intraday

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