July 25, 2018

LAW BUSINESS TECHNOLOGY
BUSINESS TECHNOLOGY LAW
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THE RECORDER
daily at www.therecorder.com
An ALM Publication

Handling the Valuation of Cannabis Companies for Private Equity and Venture Capital Clients

Investing in the cannabis industry—particularly plant-touching businesses—presents unique challenges in the current legal environment for VCs and private equity firms.

By Brett Schuman, Bill Growney and Nicholas Costanza

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In recent years, the legalization of medicinal and/or recreational (i.e., adult use) cannabis has steadily increased across a majority of states within the United States. Currently, 30 states (including Oklahoma, as of June 28) have legalized medicinal cannabis and three more states could pass medicinal cannabis legislation before 2018 is over. Nine states (Alaska, California, Colorado, Maine, Massachusetts, Nevada, Oregon, Vermont and Washington) and the District of Columbia have legalized the adult recreational use of cannabis, and voters in Michigan (and potentially North Dakota) will have the opportunity to legalize adult recreational use of cannabis in 2018, while voters in Utah and Missouri will have medical marijuana related initiatives on the ballot this year as well.

As the legal cannabis industry expands, so have investment opportunities for cannabis businesses. Veridian Capital reported "65 capital raises [for cannabis businesses] in the first five weeks of 2018, with an average size of about $19 million," and nine capital raises above $50 million.[1] Given the legal, regulatory, and economic complexities associated with operating a cannabis business in the current market, however, investors looking to participate in the cannabis industry are forced to answer a number of difficult questions including this one: How do you value a cannabis business? A cannabis business is different than a computer software business, for example, not least because the business is both licensed and legal at the state level yet criminal under current federal law.

This article identifies and provides insight into certain factors to consider from a private equity/venture capital perspective when evaluating a startup or emerging business in the current cannabis industry.

Brief Background on Recent Private Equity/Venture Capital Interest in the Cannabis Industry

Naturally, as the legality of an industry expands, so do the number of participants and revenues generated—the cannabis industry is no exception. For instance, according to BDS Analytics (a company that tracks cannabis sales data), the legal cannabis industry generated revenues of nearly $9 billion in 2017.[2] BDS Analytics and Arcview Market Research predict that "spending on legal cannabis worldwide is expected to hit $57 billion by 2027," with the recreational cannabis market covering about 67 percent of sales and the medicinal cannabis market covering the rest.[3] Innovation within the industry has undoubtedly driven revenue growth. If you take a stroll through your local retail dispensary you will not just find traditional flowers on the shelves, but instead you will likely notice a wide variety of cannabis infused edible food and drink products, cannabis concentrates (e.g., tinctures, hash oils, wax, shatter, budder, etc.), topical cannabis products (e.g., balms, creams, patches, and lotions), and an array of vaporizing devices (e.g., the immensely popular PAX devices), among other products. Apart from these touching-the-plant (TTP) products, ancillary products and services—such as software, hardware products and media, for example—also are taking advantage of the opportunity to expand their market reach into the cannabis industry. For example, technology companies are offering various software products to the cannabis industry, including CRM software (e.g., Baker), seed-to-sale software (e.g., Flowhub), and delivery software and services (e.g., Eaze and GreenRush), staffing companies are specializing in placing talent in cannabis companies (e.g., Vangst), and cannabis television is becoming increasingly popular (e.g., Viceland's "Weediquette" and "Bong Appetit").

With the federal prohibition on marijuana—through the Controlled Substancea Act (CSA)—still a cloud over the industry, cannabis related businesses historically have had to rely on "family and friends" or individual "angel" investment methods of pooling capital to fund their business, according to David Rosenthal of Gotham Green Partners, a New York-based private equity firm focused on deploying capital into cannabis and cannabis-related enterprises. According to Christian Groh, a partner at Privateer Holdings (a Seattle-based private equity firm backed by Peter Thiel's Founders Fund that focuses exclusively on investing in cannabis-related businesses), "traditional venture capital hasn't put their shoulder into this market" yet. However, that may be beginning to change. Privateer's Groh thinks that we are seeing a "global paradigm shift" and the industry is "unquestionably growing" as investments over time are moving from high-net-worth individuals to private equity and venture capital shops, and likely soon large, institutional investment companies.

Recent and notable private equity capital raises in the industry include: (i) a $17 million Series A financing in Green Bits—cannabis point-of-sale software—with contributions from Tiger Global and Casa Verde Capital,[4] (ii) a $6 million Series B financing into Plus Products—producer of cannabis infused gummy candies—with contributions from Serruya Private Equity Partners and Navy Capital Green Fund LP, (iii) a $10 million Series A financing into LeafLink, a B2B marketplace software provider connecting cannabis brands and retailers—with contributions from Nosara Capital, Case Verde Capital, and Lerer Hippeau Ventures,[5] and (iv) a $50 million investment into iAnthus Capital Holdings—a vertically integrated multistate operator—by Gotham Green Partners.[6]

On Jan. 4, U.S. Attorney General Jeff Sessions rescinded the "Cole Memoranda," the Obama-era guidelines that essentially permitted the state-legal cannabis industry to develop. Some worried about the impact of this decision on the state-legal cannabis industry, and on investor willingness to invest in it. But, the available evidence suggests that the rescission decision had little effect on the flow of capital into the state-legal cannabis industry.

TTP v. Ancillary Products/Services

Significant regulatory burdens and lack of comparative analytical data make evaluating TTP companies (e.g., dispensaries, manufacturers, cultivators, testing facilities, etc.) more difficult than evaluating companies offering ancillary cannabis products/services (e.g., software, vaporizer devices, etc.).

First, any TTP company must go through a lengthy (and potentially vigorous) licensing process in order to obtain both state and local licenses to engage in commercial cannabis businesses (at least in California). And due to the current federal prohibition, states often place significant ongoing compliance obligations on TTP companies. For instance, in California, the three cannabis licensing authorities[7] each released over

100 pages of emergency regulations that govern a wide range of ongoing compliance areas, including security, facility speculations, inventory, "track and trace" record keeping, waste management, and self-reporting, among other areas. Failure to maintain compliance can result in fines and loss of licensure, which essentially stops the business until reinstated. Although the burdens are significant, companies often find creative solutions to bifurcate the business so that only parts of it are actually touching the plant. On the other hand, companies offering ancillary products/services in the cannabis industry are not likely to have the same regulatory hurdles. For instance, from a valuation standpoint, cannabis point-of-sale software is unlikely to have any more regulatory or compliance burdens than a point-of-sale software for any other type of consumer goods.

Second, the TTP cannabis industry is still quite immature in a sense that there isn't much publicly available, industry-specific data that would be valuable to compare with a target company's business plan and financials. In addressing the issue, Groh of Privateer Holdings expressed that "when assessing a TTP business, you're basically borrowing from a couple different sectors—alcohol, tobacco, pharma, big retail; but there isn't any specific one that is directly on point." Rather, for companies offering ancillary products, such as cannabis related software, Groh noted the "valuation is easier as you can refer to comparable software companies from outside of the cannabis industry and the math regarding traffic and growth should be more straightforward." For example, a hypothetical software platform for rating dispensaries or their products could be valued by reference to similar review sites, like Yelp, TripAdvisor, etc., subject to adjustments.

In sum, investors are forced to be more creative when assessing the value of a TTP business and should try to consider data and information from comparable regulated industries (e.g., alcohol, tobacco, etc.) when appropriate.

Intellectual Property

In any financing, investor counsel spends a significant amount time in diligence reviewing the target company's intellectual property portfolio for valuation purposes, including specifically the company's existing patent and trademark rights. Startups that have secured patents and trademarks protecting their intellectual property can be more likely to generate revenue (e.g., through licensing rights or from exclusivity in the marketplace via patents, and through maintaining brand recognition among relevant consumers via trademarks). But cannabis businesses have a more difficult path to securing these rights, especially trademarks protecting their brands. Under current law, cannabis businesses such as retail dispensaries, growers and cultivators, distributors and producers are largely prevented from obtaining federal trademark protection over their consumer-facing products—which may negatively impact the company's value. Interested investors, however, may consider whether the cannabis business has taken alternative steps to protect their brand as much as possible, such as (a) filing a state trademark application in permitting jurisdictions (e.g., California), (b) using the "TM" symbol on cannabis products to preserve common-law rights, which are geographically limited to where the trademark is actually used, and (c) obtaining a federal trademark registration for ancillary, non-TTP goods or services (e.g., clothing, media, etc.) using the same or similar mark used on their cannabis goods.

Although the USPTO will not issue trademarks in connection with cannabis goods or services that violate federal law, the same agency will issue patents covering cannabis-related inventions. The USPTO issued its first utility patent to a hybrid cannabis plant to a biotech company in August 2015: U.S. Patent No. 9,095,554, titled "Breeding, Production and Use of Specialty Cannabis." For Privateer Holdings, patent protection is a key consideration in analyzing potential target companies. Groh notes that "unfortunately, a lot of strains are in the public domain already, but the ability to generate plant breeding rights is an important factor for cannabis cultivation businesses, especially on the medical cannabis side of the industry." While certain factors, such as a lack of both readily identifiable prior art for cannabis patents and enforcement of cannabis patents in the federal courts, make analyzing the value of a cannabis patent uncertain, they should be given close consideration before investing in a cannabis business with potentially patentable materials.

Beyond Single-State Cannabis Operations

While many states have legalized medicinal and/or adult-use cannabis in recent years, a cannabis business looking to expand its market reach into multiple states (and thus increase opportunities for revenue and growth) must go through the process of obtaining licensing and permitting in each state. Because this is often a difficult and expensive process with legal and regulatory uncertainties, as well as complex corporate structuring, cannabis businesses with these structures already in place are better suited to provide greater return on investments. According to Privateer's Groh, California represents "the biggest market in the world" for cannabis businesses. But cannabis businesses in smaller states may face pressure to expand beyond their home state as the market matures. As a result, investors may also consider companies operating in international markets and/or domestic markets for industrialized hemp (i.e., a variety of the cannabis sativa plant species that is grown specifically for the industrial uses of its derived products) and CBD (i.e., major cannabinoid extract in cannabis that does not have any of the psychoactive effects caused by tetrahydrocannabinol (THC)) as viable targets with potential for growth.

For instance, there are approximately 30 countries around the globe with cannabis legalized in some form. On June 19, Canada became the second country in the world, and first in the G7, to legalize adult-use cannabis, further expanding cannabis investment opportunities in Canada (beyond the existing medicinal cannabis market) when the law goes into effect later in 2018. For example, in March, Captor Capital Corp. purchased a 2.3 percent interest in MM Enterprises USA LLC dba MedMen—a now public company listed on the CSE that operates dispensaries throughout California, Nevada and New York with plans to expand its operations into Canada—for $23 million, giving MedMen a post-money valuation of $1 billion at the time.[8] Several European countries, including at least Spain, Germany, Netherlands and Denmark, have also legalized medicinal cannabis in some respects, with Germany paving the way by significantly expanding the number of patients with access to medicinal cannabis in recent years. Israel is another example of international cannabis opportunities, as Teva Pharmaceutical Industries Ltd.'s recently contracted with Syqe Medical to be the exclusive marketer and distributer of the company's medical cannabis inhaler device in Israel.

In 2017, the U.S. hemp industry generated approximately $820 million in product sales (with an estimated $190 million attributable to hemp-based CBD) and is expected to reach approximately $1.9 billion by 2022 (with an estimated $646 million attributable to hemp-based CBD), according to the Hemp Business Journal.[9] Hemp and CBD have become increasingly popular as they do not have the psychoactive effects caused by THC and are often used as an alternative to more addictive methods of pain relief, such as opioids. While the CBD market may have suffered a setback following the Ninth Circuit's denial of a petition challenging a U.S. Drug Enforcement Agency Final Rule including "marijuana extracts" (defined to included CBD) as a Schedule 1 substance,[10] more recent developments indicate CBD and hemp will continue to be viable markets and may become free of the federal prohibition faster than cannabis generally. Specifically, just last month the FDA approved an epilepsy medication made with CBD, which will be the first cannabis-derived prescription medicine to be made available in the United States. In late June 2018, the U.S. Senate overwhelmingly passed the 2018 Farm Bill, which included an amendment sponsored by Senate Majority Leader Mitch McConnell that removes hemp (and hemp-derived CBD) from Schedule 1 and would thereby fully legalize hemp at the federal level.

In sum, investors looking beyond single-state legal cannabis businesses may consider whether a target company has access and/or potential to access to viable international cannabis markets, as well as domestic CBD and/or hemp markets, when determining the company's value.

Access to Banking

One the biggest hurdles for cannabis businesses is securing access to U.S. banking. Although access to the federally regulated banking system is not absolutely prohibited under current law, it is complicated by regulatory burdens and most major banks will not do business with those in the state-legal cannabis industry. Privateer's Groh thinks that there is a "lot of pressure on regulators to fix banking" issues for the state-legal cannabis industry, given the increasing amount of money flowing into and through the industry. But, in the meantime, potential investors must take extra steps during the due diligence process to ensure satisfaction with a target company's cash management and financial controls. David Rosenthal, of Gotham Green Partners, stressed how important a company's banking strategies are in this industry given lack of reliable access. Rosenthal explained that his firm will often dig deep into a company's financials during the due diligence process (as would be common for an investor conducting diligence in any industry) but also into a company's cash management system and banking relationships "beyond merely asking for copies of bank statements." Further, if a target company seems valuable but does not have a proper financial strategy in place, they will often work with the company in order to find a better solution. The lack of a clear path on banking, which may require a company's management team to adapt on the fly, is illustrative of a broader point about the particular importance of investing in quality management. Rosenthal emphasized the value of "human capital" that Gotham Green Partners places on their deals, stating that there "is often a level of trust that may not be required in other industries, and finding executives who are a mix of forward-thinking and resourceful is vital in an ever-changing environment."

Conclusion

Private equity and venture capital are starting to make their way into cannabis. But investing in cannabis businesses—particularly plant-touching businesses—presents unique challenges in the current legal environment. A proper valuation will often depend on a different sort of due diligence process for analyzing market comparables, intellectual property assets, financial due diligence, prospects for business expansion and growth, and state-level licensing, among other relevant considerations.

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[1] *See* https://mjbizdaily.com/viridian-investment-money-pouring-cannabis-industry/.

[2] *See* http://ktla.com/2018/01/31/u-s-legal-weed-industry-generated-9b-in-revenue-in-2017/.

[3] *See* **https://www.forbes.com/sites/thomaspellechia/2018/03/01/double-digit-billions-puts-north-america-in-the-worldwide-cannabis-market-lead/#127c0ebe6510**

[4] *See* https://www.prnewswire.com/news-releases/cannabis-point-of-sale-and-compliance-platform-green-bits-raises-17-million-in-series-a-round-300631870.html.

[5] *See* http://www.businessinsider.com/leaflink-raised-17-million-in-series-a-to-expand-cannabis-tech-2017-11.

[6] *See* https://www.prnewswire.com/news-releases/gotham-green-partners-invests-us50-million-in-ianthus-to-accelerate-growth-initiatives-300647958.html.

[7] California Bureau of Cannabis Control (for retail, distribution, and testing), the California Department of Public Health (for manufacturing), and the California Department of Food and Agriculture (for cultivation).

[8] *See* https://globenewswire.com/news-release/2018/03/29/1455602/0/en/Captor-Capital-Corp-Announces-Closing-of-MedMen-Investment.html.

[9] *See* https://www.hempbizjournal.com/size-of-us-hemp-industry-2017/.

[10] *See Hemp Industries Association v. U.S. Drug Enforcement Administration*, 720 F. App'x 886, 887 (9th Cir. 2018).

Brett Schuman *is the chair of Goodwin's San Francisco office as well as co-chair of the firm's cannabis practice. He also is a partner in the firm's IP litigation group, focusing his practice on patent and other IP litigation.*

Bill Growney *is a partner in the firm's technology and life sciences group as well as a member of its cannabis practice. He focuses his practice on advising technology and other startup companies, including those in and relating to the cannabis industry, through their full corporate life-cycle.*

Nicholas Costanza *joined the firm in 2018 and is an associate in the firm's litigation department. Mr. Costanza is also a member of the firm's cannabis practice.*