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Covid-19 Cannabis Industry Report

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COVID-19 Cannabis Industry Report

The State of Cannabis Markets Amidst Pandemic Uncertainty

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Key Takeaways

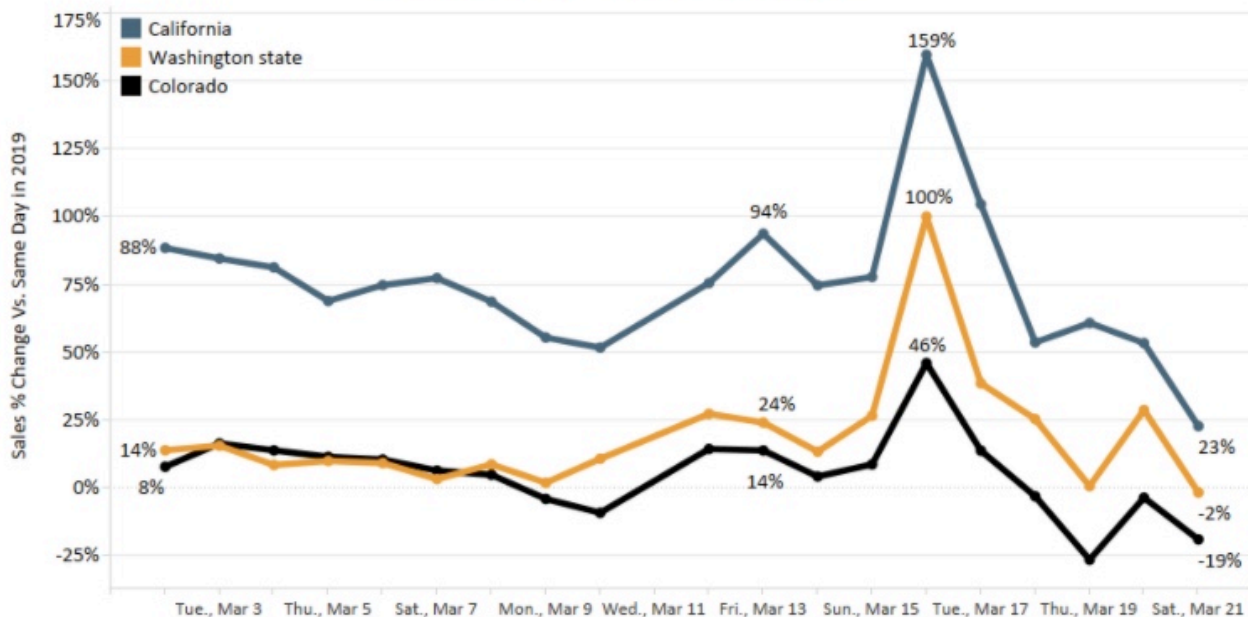
- Despite COVID-19's economic strain, cannabis sales continue to skyrocket as consumers use products to cope with anxiety and uncertainty of the pandemic
- COVID-19 has changed what cannabis products consumers like. There has been a dramatic decrease in vape/smoke products, however, a large increase in edible products
- The economic uncertainty caused by the pandemic has clearly caused investment activity to slow, but it has not come to a halt. Investment firms with excess cash on hand are able to continue investments into cannabis companies that are established and financially sound enough to sustain the negative economic impacts caused by COVID-19
- Medical cannabis: from illegal to essential

Highlights & Trends

As the American Cannabis Operator and Canadian Cannabis LP indices continue to plummet to 52-week lows, a number of cannabis companies are running low on cash. It is clear the relentless strain that COVID-19 has placed on the economy is yet to show any mercy on the public markets.

In 2019, the North American Cannabis Market reached approximately \$14 billion, growing by almost 30% on the year. 2020 has seen a brief pullback of the rapid growth within the cannabis market as a result of slower developing opportunities caused by the lack of continuity between the regulatory and legal environments of each state and country. It is also important to consider the future opportunities available as cannabis companies across North America are granted permission to begin sale of edibles, topicals, and other revolutionary products.

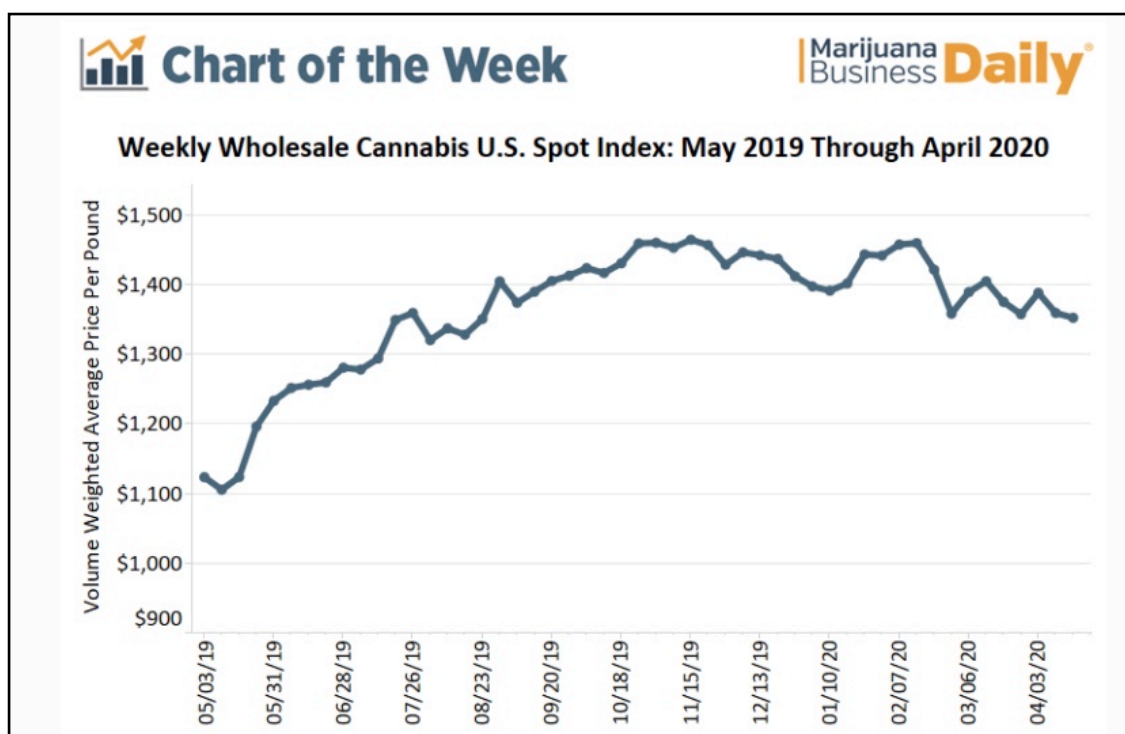
**Adult-Use Cannabis Sales in March 2020 by Day and Market:
Percent Change Vs. Same Day in 2019**



Source: Headset
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March 16th, 2020 marks the peak of cannabis sales in some of the largest cannabis markets in the US. It also marks the day in which the Corona Virus Task Force released new drastic guidelines to stem the spread of the virus, sparking fear and anxiety amongst many Americans. Soon after, there is a dramatic decrease in sales due to previous stockpiling.

Despite overall economic downturn due to the uncertainty regarding the pandemic, COVID-19 has not been a complete disaster for the cannabis market. Vice industries, including cannabis, are still deemed to be recession-resilient. Cannabis sales in recent weeks, including delivery sales, have spiked as the number of people using cannabis to cope with the persistent anxiety during lockdowns across the US and Canada rise. Consumer stockpiling due to fears of dispensary closures also contributes to the demand spike.



US Wholesale Cannabis prices end 2019 strong, however have been in fluctuation since the beginning

Investment Activity

Money continues to move. Capital groups with excess cash are in a much better position to continue investment during economic uncertainty. As of early Q2, a number of cannabis ventures have successfully raised capital:

- *May 12th* GrowFlow Cannabis Software Company raises \$8.4 million in growth round lead by TVC Capital
- *April 16th* GreenBits Cannabis Retail Platform raises \$23 million in Series B round led by Tiger Global Management &

Casa Verde

- *April 13th* Green Acre Capital leads \$25 million Fire & Flower Convertible Note Financing
- *March 16th* Indus Holdings & Investor Group Lead by Geronimo Capital Announce Bridge Financing and Terms for Total Financing of up to \$14.5 million

Market Risks

As in all industries, investing in cannabis offers a trade-off between risk and reward. In the past, cannabis has been associated with relatively high risk in both the private and public markets primarily due to its continued federal illegality in the US. As the industry develops, legality across the globe has steadily increased, easing investor tensions from a legal standpoint. Today, cannabis is legal for recreational use in 11 states and DC, for medical use in another 22, and in some varying limited capacity in another 13 states. In each of which it is subject to valuation, dilution, and commoditization risks as emphasized by *The Motley Fool*¹.

Valuations in cannabis pose their own unique risks for several reasons. One crucial component to the valuation methods relies on the sales and revenue projections of a company, and what is determined to be the present value of its future cash flows. Since cannabis sales have become legal to the public (subject to each states' laws) in the US and Canada only a few years ago, many companies base financial projections on historical figures that includes black market data. This leads to weak or misleading valuations and increased risk on behalf of the investor. Downward price pressure from the black market's continued existence squeeze legitimate companies' margins even further.

¹ Speights, Keith. "Timeline for Marijuana Legalization in the United States: How the Dominoes Are Falling." *The Motley Fool*, The Motley Fool, 24 Sept. 2018, www.fool.com/investing/timeline-for-marijuana-legalization-in-the-united.aspx.

The harsh regulatory environment for legitimate cannabis companies means the absence of traditional sources of finance, such as banks, which increases the risk of dilution when investing in cannabis companies. Dilution in investor ownership occurs as more shares are sold by the company to finance operations. Cannabis companies, for the most part, are forced to go to the private markets to raise funds as opposed to traditional finance sources due to the regulatory obstacles these institutions face. As the legality of cannabis continues to develop, increasing sources of finance will allow for a greater distribution of risk.

Although not a high level of concern at present, the cannabis industry also faces increasing potential exposure to the risk of commoditization. Prevalent throughout the agriculture sector, commoditization risk occurs when a product becomes standard across an industry, distinguishable only by price. Cannabis being an agricultural product does run the risk of becoming a commodity, however, the vast amount of products created from the plant, along with continuous product innovations, protect it from a high level of risk for the time being.

Investor Sentiment

Despite the risks, investor sentiment remains positive, and increasingly so, in the private market for larger established cannabis companies that can sustain the current temporary economic uncertainty. Cannabis is here to stay, with investor confidence increasing as worldwide legalization continues to spread, fueling a positive outlook. With volatile public markets, investors turn to private companies with strong sales and fundamental valuations.

Although the long-term holds overall positivity, investors remain reluctant to invest in small, young cannabis companies with a primary concern being the inability to cover immediate costs while operating at slim margins. As unemployment rises, consumers are seeing a decrease in discretionary income, forcing the general population to stick with products they already know.

Steep barriers to entry, such as tremendous startup costs and extensive licensing processes, make it difficult for new companies to establish themselves. Even as they do, regulatory restrictions force thin margins and fierce competition with larger companies with experience and resources to overcome those obstacles. Investors who are open to the risks of investing in the industry are not likely to place bets that smaller companies are going to survive.

What they are likely to bet on, however, is the tremendous consolidation within the industry as larger companies recognize valuable IP in newcomers, such as brands, products, or supply chain efficiencies, and roll them up through acquisition. Therefore, smaller players must find a strategic advantage that demonstrates a considerable value proposition in order to attract investors.

Valuations

Valuations in the cannabis industry are quite unique. At this point in the industry's development stage most companies are not yet turning a profit. With the lack of profit in companies across the board we tend to veer away from multiples such as Price/Earnings, and instead utilize EV/Sales and EV/EBITDA.

Date	Target	Acquirer	% Acquired	Transaction and Company Financials (C\$ millions)				Multiples	
				Total Purchase Price	Implied Enterprise Value	LTM Revenue	LTM EBITDA	Implied EV/ LTM Revenue	Implied EV/ LTM EBITDA
5/16/2019	BillsCo Cannabis Corp	The Supreme Cannabis Co Inc	100%	47.9	48.1	NA	(3)	N/A	(17.0)
3/21/2019	Quadron Cannatech Corp	World Class Extractions Inc	100%	20.7	19.8	4	(6)	5.4	(3.5)
3/13/2019	Newstrike Brands Ltd	HEXO Corp	100%	260.2	164.1	8	(29)	20.8	(5.6)
2/14/2019	MPX International Corp	Undisclosed Acquirer	55%	27.0	21.8	0	(1)	2344.3	(27.9)
12/7/2018	Cronos Group Inc	Alltra Gp Inc	45%	2365.3	2855.7	13	(22)	236.3	(132.1)
11/21/2018	Alternative Medical Solutions Inc	Cannapharmax Inc	100%	12.6	12.6	NA	NA	N/A	N/A
11/20/2018	Clarity Cannabis Medical Centre Inc	Choom Holdings Inc	100%	1.2	1.2	NA	NA	N/A	N/A
11/15/2018	Growforce Holdings Inc	Mjardn Gp Inc	100%	240.6	240.6	NA	NA	N/A	N/A
9/10/2018	IOC Labs Inc	Aurora Cannabis Inc	100%	273.7	263.8	23	6	12.4	45.1
8/27/2018	NextLeaf Solutions Ltd	Legion Metals Corp	100%	32.4	32.4	NA	NA	N/A	N/A
8/15/2018	Canopy Growth Corp	Constellation Brands Inc	75%	5112.2	10747.9	93	(137)	122.1	(78.5)
7/30/2018	Canna Farms Ltd	ABCann Global Corp	100%	127.3	127.3	NA	NA	N/A	N/A
7/10/2018	Hiku Brands Co Ltd	Canopy Growth Corp	100%	250.9	245.8	NA	(5)	N/A	(5.27)
5/14/2018	MediLeaf Corp	Aurora Cannabis Inc	100%	2918.6	2712.6	45	(42)	62.5	(64.8)
High								2344.3	45.1
Average								400.6	(37.5)
Low								5.4	(132.1)

Source: Thomson Reuters

As COVID-19 continues to test our global economy, M&A activity within the cannabis sector has continued to decline. Since the end of 2019 there has been a precipitous decline in cannabis M&A transactions according to Scott Greiper, Present of Viridian Capital Partners. In Q1 2019 there were 94 M&A deals and by Q1 2020 there were only 19. Similarly, March 2019 saw 19 M&A transactions while March 2020 only saw 5.

When valuing a cannabis company there are a number of lenses one must analyze the company in. It is crucial to examine each revenue generating operation per state separately. A number of large cannabis businesses claim substantial revenue growth via numerous acquisitions in the space. The latter should be viewed as an increased company footprint, not a measurement of improved business performance.

When constructing valuation models within elusive markets there are a number of issues that arise, which often leads to weak valuation methodology. One issue that remains in the spotlight is the vastly used metrics for measuring production. With a wide variety of products on the market, cannabis firms may choose to measure their production output in the form of weighted dry-flower, concentrates with varying potencies, or even pre-packaged "pre-rolls". The varying metrics for production has proven to be a difficult challenge causing messy valuations.

Another major, ongoing valuation issue that has hurt a number of companies, and in turn, investors, is "Goodwill". First-movers in the cannabis industry faced fierce competition as several companies started emerging as industry giants. As they grew, along with many others who continue to emerge today, these companies turned to acquisition-heavy strategies in an effort to become the dominant forces in the industry. Each of them seeking out several smaller companies with unique competitive advantages to roll up, lead to extensive overvaluing of intangible assets (i.e. brand popularity, reputation, customer loyalty, etc.) in an effort to close acquisitions quickly. As time goes on and companies begin to realize how much they overpaid for these "Goodwill" assets, they're written off on the balance sheets, sometimes leading to large dips in valuation.

The legal cannabis industry, as young as it is, has little significant historical information in which experts can base company valuations off of. The two common valuation approaches used in modern day finance are the market-based approach and the income-based approach. A market-based approach valuation is derived from comparable assets such as public company multiples and precedent

transactions. When valuing a young industry such as cannabis, multiples offer a more reliable measure compared to historical revenues. As of Q2 2020, there are still many cannabis companies that do not see a profit which offsets the benefit of viewing multiples as a basis of valuation, as an unprofitable company will struggle to see a strong valuation. M&A activity in the cannabis industry is relatively high. Each transaction offers an example of commonly accepted valuation methods which has proven useful in valuing cannabis companies.

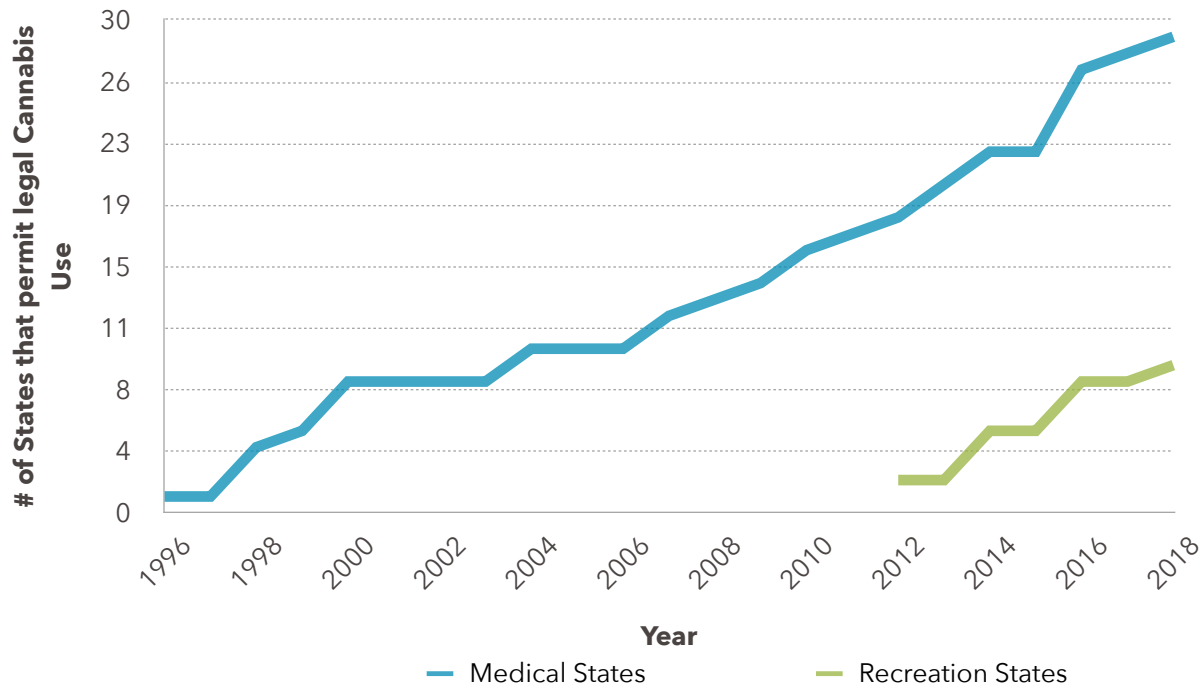
An income-based approach is derived from potential future cash flows discounted to a current date (Discounted Cash Flows). While this forward looking approach may be useful, the uncertainty of future cash flows due to the youthfulness of the industry can lead to a weak valuation. Income-based approaches, like the DCF, do allow us to measure complex risks within the future market, however, the validity in calculating the risks will remain something of debate.

Regulatory Environment

The regulatory environment in cannabis is one of rapid change. Colorado became the first state in the US to legalize recreational cannabis in 2012. Since then, 11 states have opened doors to recreational cannabis and 35 states have allowed medical use in some capacity. To this day cannabis remains federally illegal in the US, causing an inconsistent regulatory environment. Despite the complexity of cannabis' regulations, there is an overall trend of increasing legality and easing of regulations across the US and Canada.

The MLB sparked change in the professional sports industry and its regard towards marijuana. As of December 2019 the professional sports league removed marijuana from the list of banned substances. Not too long after, in April of 2020, the NFL's new Collective Bargaining Agreement declared that players who have tested positive for cannabis will not be suspended. The MLB and NFL are just a couple of the organizations to recently ease regulations regarding the substance.

US: Increasing Legality Over Time



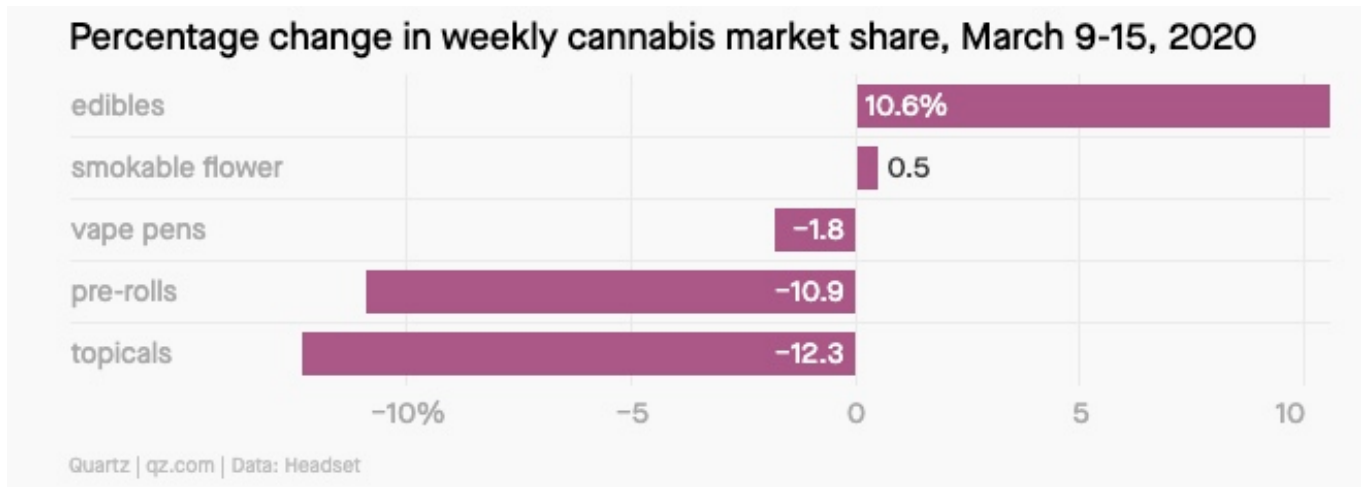
As depicted above, cannabis legality continues to grow to new highs every year which allows for an expanding market place and increases in demand.

In other efforts to improve the regulatory environment of cannabis, The SAFE Act (Secure & Fair Enforcement Banking Act) has removed a number of obstacles faced by cannabis businesses. The SAFE Act was passed by the House at the end of 2019 and provides protection against the penalty of depository institutions for taking on cannabis clients. Cannabis businesses operate on a high cash-transaction basis and can not utilize the safety or convenience provided by banks. Without banking services, cannabis businesses not only struggle to manage cash, but also remain unsafe for employees and customers as an abundance of cash must be stored on site. The bill still awaits a vote in the Senate.

Since COVID-19's stress on the economy, many relief bills have been passed to aid businesses around the US. To industry delight, The SAFE Act was included in the House Leadership's Coronavirus Relief



Bill according to *The Marijuana Moment*². As of this writing, that relief bill is also awaiting a vote by the Senate.



The Vaping Crisis of 2019 is not the only factor pushing consumers away from smokable/vape products. Due to COVID-19's properties, many consumers are worried about their lung health and are turning to edibles as a safer way to consume cannabis especially during the pandemic.

A more controversial and unresolved regulatory issue in cannabis lies within The MORE Act (Marijuana Opportunity Reinvestment & Expungement Act). This act will reevaluate individuals incarcerated for marijuana-related crimes in states where marijuana is no longer illegal. Many believe it is wrong to fill prisons with people who have committed drug-related crimes that are no longer deemed a crime. On the other hand, many believe that no matter what the legal environment may be, one is responsible for abiding by the law. The MORE Act is currently being reviewed by a number of committees as the public awaits a report.

New Products

Cannabis is a creative industry with a number of dedicated professionals working to develop innovative methods of consumption to fit every individual. The Vaping Crisis towards the end of 2019 marked a pivotal turning point in the types of popular cannabis

² Jaeger, Kyle. "Marijuana Banking Access Included In House Leadership's Coronavirus Relief Bill." *Marijuana Moment*, 12 May 2020, www.marijuanamoment.net/marijuana-banking-access-included-in-house-leaderships-coronavirus-relief-bill/.

products. Prior to the crisis, THC vape cartridges were amongst the most popular products on the market. Since then, the scare has caused many people to switch consumption methods to infused edibles and drinks. According to *Benzinga.Com*³, with the help and development of micro-dosing, many individuals are trying THC-infused products with the comfort of knowing they may not feel any psychoactive effects.

Success Stories

The devastation and strain that COVID-19 has brought on society is no match for the high-spirited individuals pioneering the cannabis industry. As of March 26th, 2020, according to MJBiz, a number of cannabis companies across the country have augmented operations to produce hand sanitizer gel to help curve the pandemic's spread. These actions taken by cannabis professionals not only benefit society, but also benefit the cannabis industry's reputation and customer base.

Amidst the lockdowns experienced throughout the world, many states, local governments, and municipalities declared cannabis businesses essential and to remain open despite most businesses being forced to close. When just a few short years ago cannabis was illegal throughout the world, it is now relied upon by millions as a crucial source of medicine, therapy, and income.

Still in the throws of the pandemic, the road ahead is filled with uncertainty and challenging times for virtually every industry. However, if there's any positivity that could come from this crisis, it's the case that can be made for the legitimacy, and federal legality, of the cannabis industry, solidifying its place amongst its peers throughout the supply chain. The policy reforms soon to come will be a guiding light for the future of legal cannabis everywhere.

³ Goldleaf. "Microdosing: The Secret To A New Cannabis Experience." *Benzinga*, Benzinga, 9 May 2020, www.benzinga.com/markets/cannabis/20/05/15970460/microdosing-the-secret-to-a-new-cannabis-experience.