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INTERNATIONAL DUE DILIGENCE ORGANIZATION

IDDO Cannabis Business Due Diligence

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Cannabis Due Diligence: The Science and the Business

Interest in cannabinoids from both a recreational and therapeutic/medical point of view is exploding - and that may be an understatement. When one gets unsolicited advice on how to use cannabinoids at a conventional dinner gathering, it is time, as they say, to blow the whistle.

The research done on cannabinoids to date is deeply flawed in three critical areas. The first flaw has been not using standardized and well-controlled substances to test. The US government weed formerly used in official studies was generally of low potency and of irregular consistency. This poor quality control renders the results of those studies flawed and useless from the outset. Furthermore, even if this problem has been overcome, the cannabis used would still be unrepresentative of the vast range of strains and products available in the market today, meaning the research results could at best only be indicative and to us not scientifically valuable.

The second flaw has been in the size of the studies, which have typically been on sample sizes under 500 subjects. Until the population size of a study is sufficiently large, even small variances in the data can unacceptably skew the results. Future research study controls must be rigorously controlled for key factors such as patient biases in self-reporting. Few such studies currently exist.

The third flaw is in reproducibility. Reproducibility is crucial to any studies ultimate validation. If the study cannot be successfully reproduced, it remains officially "anecdotal" and not regarded as "scientific." Again, few such studies have been reproduced, and therefore while the results of a study may be exciting - it is not yet science.

Science is, after all, a tough discipline – and the science of cannabis even more so.

For example, according to Nature Magazine over half of all published psychology studies cannot be reproduced. Common failures cited: sample size too small, applicability creep, cherry picking of data points, conflict of interest, "p" farming, etc.

It is true that the ability to perform properly detailed scientific research on cannabis has been to date severely constrained by a variety of factors. However, by using the latest modern technology we now possess the tools to address most of these issues, and where marijuana is legal there now exists all the opportunities to conduct proper in-depth scientific research.

As most large-scale research is funded with federal dollars, and cannabis is still federally illegal in the United States, it is unlikely the industry can rely on funds from the Federal Government. Meanwhile, the growing culture of popular belief in the media is that marijuana is a miracle drug, and could even be the fabled "universal panacea" cure all. While this may or may not be true, the authors here are betting on some good effects properly substantiated. There is an urgent need for the type of quality research to establish a reliable knowledge base on the efficacy of cannabis products.

The FDA so far has only fully approved three cannabinoid-based drugs for human use: Marinol and Syndros, synthetic versions of THC, and Cesamet that has synthetic cannabinoids similar to THC. These are the current potential choices for physicians treating the side effect of cancer treatments and other conditions that create severe nausea.

While several other promising candidates are performing well in advanced clinical trials, including an oral spray containing cannabinoids that are already available in many countries, the industry must still wait for the definitive research results. The fact that at least these three cannabinoids have been approved by the FDA does demonstrate bioactivity of some of the cannabinoids. It is also predictable that more cannabinoids will be found to possess beneficial effects.

The research will still be a Herculean task, as cannabis contains an estimated 500+

chemicals, of which 85% are cannabinoids. Properly structured scientific research is therefore urgently needed to understand the bioactivity of each of the cannabinoids. With this understanding, this former cottage business will successfully transition to a global professional industry.

So if you are already involved or contemplating involvement in the burgeoning cannabis industry, take time to find and review the good science that is being produced. Base any claims you may have on reliable studies, making certain that what was grown, sold, or consumed has been properly tested and the research has clearly documented and disclosed the “seed-to-sale” supply chain.

We, as an industry, must be very cautious about claims for the benefits that can be derived from cannabis, either by ingestion or topical use. False or unsubstantiated claims are likely to get your business (or your investment) wiped out by the regulators – just like in any other professional industry.

Cannabis and cannabis businesses are currently all the rage. The industry has been called the new frontier, the “green rush”, like the beer industry after prohibition – everyone wants some. California’s legalization in late 2016 only added fuel to the speculative fire. The gold rush mentality of investing so far has been great for those providing investment opportunities but has proved costly for those who were not prepared for the hard realities of an industry in transition.

The due diligence needs of the cannabis industry far exceed conventional business requirements. While standard fact-checking such as verification of the backgrounds of management, the status of the licensed entities, and rational assessments of the business plan are absolutely required, so much more needs to be addressed. The unique issues facing the industry are those of an illegal business turning legitimate, and of a cottage industry becoming commercialized.

Without a doubt, a huge range of exciting opportunities exist for investors, including in the core operations of growers, middleman, makers of cannabis products, retailers, etc. and in suppliers of ancillary products to the industry, such as legal services, accounting, consulting, technology, etc.

However, some key things must crucially be addressed first: for example, the profit potential of the industry depends to a large extent upon the price of cannabis. The market pressures of supply and demand are an essential factor in the success of any business. Careful analysis must be made of the current and projected volume of products coming online, balanced against the requirements of the different groups of consumers.

A delicate, constantly shifting balance determines the price of cannabis. What we typically see when cannabis is legalized in any location, is an initial spike in demand due to locally restricted supply resulting in strong prices, which within a matter of months results in supply expanding and new growers entering the local market, as well as supplies of illegally smuggled cannabis coming in from other states.

The initial impact of this is a rapid decrease in the market price of cannabis. In one region of California for example, spot prices went from $2,700 per pound to $1,450 in the span of 100 days following the vote to legalize cannabis. This volatility of pricing impacts everyone in the value chain and can wreak havoc on business profitability and unrealistic business plans.

Cannabis and THC-containing cannabinoids are prohibited from crossing state lines, but that does not mean that it does not happen. There is a lucrative trade in shifting supply from oversupplied regions to underserved regions. Meanwhile, cannabis extracts possessing only trace amounts of THC and cannabinoids derived from stems and seeds can travel more freely, whereas cannabis plant material generally cannot.

The scope of the actual laws goes well beyond the general permissions assumed as part of the legalization process. The laws impose stringent prescribed operational frameworks for the participants, with each state setting forth its own residency requirements for companies, management, and investors. While owners can hold their investments in holding companies, ultimate beneficial ownership must be disclosed. Comprehensive background checks on all employees, owners, and investors are required. Licensed business must also ensure that any third parties they contract with are also properly licensed. These essential matters of licensing, compliance and verification take a great deal of time and up-front expense.

It is legally difficult and very risky to invest across state lines. This difficulty makes vertical integration less attractive and makes it near to impossible to cost-effectively grow a multi-state cannabis enterprise. The differing state-by-state requirements restrict investor and investment choices, as well as limit the upside for any particular licensed operation. The mere fact that money crosses state lines to fund a federally illegal enterprise exposes both the investor and the enterprise to federal wire fraud and money laundering charges.

Even within a state that has legalized cannabis, some cities and counties have passed laws making aspects of the cannabis business illegal. The legal landscape is anything but homogenous from state to state or even within a state.

Driving while under the influence of cannabis has also become an issue. While standards have been set for alcohol, no similar numerical standards have been set for THC levels. Many states suggest that any level of THC should be considered an impairment. Admittedly this is a ludicrous approach, but the prosecutors have found the assertion to be effective in prosecution. This position of the law enforcement community exposes any establishment that sells cannabis for on-site consumption to be held liable for "over serving" a patron if the patron gets in an accident after departing the establishment. The liability can be raised and might even be upheld, even if there is no tangible sign of impairment in the patron.

Finally, the notorious section 280E of the US tax code prohibits "illegal businesses" from taking standard business deductions. This is very hard on business margins.

The new cannabis entrepreneurs range from pre-legalization enthusiasts from the previous cottage businesses to sophisticated businessmen schooled in industrial practices. The enthusiasts have operated illegally for many years and often find it hard to change their style of operation. As due diligence specialists, we have found some of their behaviors counter-productive to effective functioning in a transparent commercial environment.

The sophisticated businessmen on the other hand often find working with the enthusiasts difficult as the latter still rely on a well-established former network of buyers and a distribution chain only now emerging from the shadows into the light. Assuming none of the enthusiasts have felony convictions, these networks can be hard to break into. Old friends and alliances from the prohibition days are still very common in the cannabis industry.

After the end of the alcohol prohibition in 1934, there were almost 800 brewers of beer in the market. By 1981 there were just 51 brewers, with the top 6 brewers controlling 92% of the market. We believe the same will happen in the cannabis industry, with many enthusiasts coming out of the shadows after legalization, with only a few of them surviving in a commercial marketplace.

Most cannabis operations, if they are honest with their bankers, find they cannot operate conventional bank accounts. The costs associated with handling bulk cash are considerable as well the risks of theft. The enthusiasts have been dealing with these issues for years and can often revert to former bad habits, whereas the sophisticated businessmen need to be hyper-compliant and are forced to make the best of uneconomic choices. These cash management and cash-in-transit issues poorly handled can make an otherwise promising business uncompetitive.

In Colorado cannabis-related traffic deaths increased by 154% between 2006 and 2014, hospital emergency room visits “likely related” to marijuana increased by 77% from 2011 to 2014, and drug-related suspensions/expulsions from school increased 40% for school years from 2008/2009 to 2013/2014. This all according to a September 2015 report by the Rocky Mountain High-Intensity Drug Traffic Area, a collaboration of federal, state and local drug enforcement agencies.

This report also found that the proportion of marijuana-related traffic fatalities to traffic fatalities as a whole increased as well: in 2014, marijuana-related traffic fatalities made up 19.26% of all traffic deaths, up from 6.92% in 2006. While dramatic, this study does have some flaws: often the person found to be impaired had consumed more than one form of an intoxicant, the most common being alcohol.

Nonetheless, these trends have sparked a significant public policy debate that may influence legislation in other states. The campaign in Arizona to legalize cannabis in 2016 failed in large part because of the Colorado effect, and it is worth remembering that a state that once voted to legalize cannabis can also vote to prohibit it again.

The industry is poised for even more significant inbound investment flows starting in the next few years. In 2016 Colorado exceeded $1 billion in sales of cannabis, not including the sales of topical creams and lotions. Recent estimates of the size of the US cannabis industry see it exceeding $25 billion by 2020, and in all likelihood that figure is low.

Financing for cannabis operations is not just difficult it is complex. If you are looking to raise from $10,000 to $1,000,000 of equity your cost of raising funds is going to be from 18% to 22% in commissions. If the cannabis business is are looking at debt financing, they should expect to pay 5 points, and 15% to 18% interest on the debt.

Why so high? The cannabis business is a cash-based business with all the inherent risk of a cash-based business compounded with the inability to bank proceeds. While the industry regulations are strict, and while there is now good tracking from seed to sale, the opportunities for abuse abound. There also exists the uncertainty of how to exit a cannabis-based investment. Does the investor get paid in cash, will there be a buyer in two or three years, what is the future competitive pressures a cannabis business will face? These are all significant and real imponderables that have to be addressed as best they can. So in short, why is the finder fee so steep?

The demand for investors willing to invest in cannabis businesses is high, and the investor pool is small. The introducers know the market and are charging the price for access to their pool of investors.

For cannabis based business investments over one million in equity, if you do find a passive investor, the rates are typically 10% to 15% commission plus whatever percent equity is agreed upon. However, from what we have been seeing the large investors are not passive. The larger investors typically take an active roll in the business to over see how their money is being used, and to the greatest extent possible, ensure the success of their investment. Investing millions into a cash based business has all of the recipes and imponderables to make those investors rightfully nervous. Investors or investor groups that are investing five million or more will typically structure a buyout with some form of trailer or participation for the founders.

This is a US centric look at the cannabis industry. Canada with a unified legal structure for prescription cannabis possesses what some might argue as a better opportunity. The Canadian legal cannabis industry is not facing constant legal challenges, is growing in an economically fruitful and legally harmonious environment and thus, possess greater margins. But that would be another white paper.

However just as the opportunities are significant, so are the risks. The risks result primarily from the transition of an illegal cottage industry to a fully commercial business, the inevitable consolidation that will occur as a result, and the legal "no man's land" created by the patchwork quilt of inconsistent and contradictory laws.

Major investments should only be made after detailed and experienced investigation of all the facts of the business and the conditions of the market. Get these essential preliminary steps right, and the above average returns achievable are more likely despite the significant risks of operating in this exciting new industry.

By:

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