Cannabis sector consolidates as investors join second rush for 'green gold'

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Investing activity in the cannabis space is on the rise, as investors take advantage of lower prices and companies seek opportunities to merge – bolstered by anticipated changes at US federal level that would, at the very least, secure legal state markets.

However, as cannabis companies have rushed to gain funding, there could be the start of a decline in the number of businesses as competition with better funded rivals, as well as mergers and acquisitions, start to take a toll, some experts argue.

"The cannabis industry in the US alone is highly fragmented, with over 40,000 businesses. As it matures, we expect that number to decline significantly," said Sumit Mehta, CEO of San Francisco-based cannabis investment firm Mazakali.

Part of that decline could come from merger deals, as smaller and medium-sized companies find it easier to compete by banding together or merging with a larger company.

Take, for example Stem Holdings, a US-based recreational cannabis company, which recently acquired cannabis delivery firm Driven Deliveries. Stem has been on a massive mergers and acquisitions (M&A) hunt and now has total control of the entire supply chain, from seed to delivery, said CEO Adam Berk.

"One of the greatest things when we acquire these companies that we do is we pull out HR, we pull out administration and we pull out accounting and we pull out finance, we pull out all of the difficult parts of this business and we allow these operatives to go back to running the day-to-day cannabis business," he said.

Innovative financing tools

According to data from Viridian Capital Advisors, the number of deals in the sector started to pick up in August and September after a COVID-19 slump, although they are still nowhere near where they were in 2019.

And it's not just M&A deals that are starting to pick up. Holistic Industries raised $35m in debt funding in September, while Subversive Real Estate announced in mid-October that it was merging with Inception REIT in a $183m deal that will make it the second publicly traded cannabis real estate investment trust (REIT).

REITs are innovative financing tools allowing cannabis companies that cannot secure bank loans to get financing. It works by creating a fund that cannabis companies sell their real estate to and then lease back. The cannabis companies get an immediate cash injection, the fund gets a steady source of revenue, and investors interested in the growth rate of the cannabis sector but worried about perceived taint can invest at arm's length.

However, REITs remain a relatively new innovation in the cannabis sector. One of the funding tools being used more often in the last few months are SPACs, or Special Purpose Acquisition Companies.

These are companies formed for the sole purpose of raising money through an initial public offering in order to buy another company. One of the reasons SPAC activity is on the rise is because their investing timeline is running out. Essentially, if these companies don't buy companies, then all the money is returned to investors.

Political change in the US

According to Mehta, there are seven or eight SPACs in the industry that are closing in on their timeframe to complete deals. Some of these have an average asset size of $180m, with some worth twice that. "I think they are going to have a difficult time finding many cannabis companies of that size that are also willing sellers at current valuations," he said.

But it's not just consolidation or timelines that are causing a push towards cannabis investments, says Mehta. Another reason cannabis investing is expanding is because of anticipated political change in the US.

"There's increasing confidence that we will see effective federal legalisation in 2021. This doesn't mean that the feds legalise, it may mean that the feds decriminalise, reschedule or deschedule," added Mehta. "No matter what it means specifically, if states are given free rein that is a massive boost for an industry that less than a year ago was largely deemed illegal and for the past six months has been deemed essential."

Arizona, Montana, New Jersey and South Dakota have all passed recreational cannabis measures, while voters in South Dakota and Mississippi also passed initiatives to allow medical cannabis.

The Democratic Party under president-elect Joe Biden also appears to be generally in favour of decriminalising cannabis at federal level – though enough ambiguity remains to give leaders some wiggle room if they decide that is not a path they wish to follow.

Eating into the black market

As more and more Americans look favourably on cannabis legalisation, it has eaten into the share of the black market, which is recreational cannabis's biggest competitor, said Berk: "That's one reason people want to invest in these states and these businesses, because they know their largest competitor is starting to lose a ton of market share throughout the entire country."

In fact, beyond legislative efforts, consumers have been driving demand away from the black market and to legal sources due to safety concerns around the coronavirus pandemic, Berk added.

"When regulated cannabis companies make pre-rolls, you know people are using gloves and masks. In the illicit market, you don't know if the person making that pre-roll is licking the paper or how they are sealing it," he said.

With the increase in funding, the question inevitably rises: are we seeing another cannabis bubble like we saw in 2018?

"Investors are generally very aware of recent history. I think many of the people who invested and drove the industry high weren't the large institutional investors, it was a lot of retail capital that facilitated that," said Geordie Hadden-Paton, associate director at Chrystal Capital Partners, which recently launched a medical cannabis and CBD fund for European investors called Verdite Capital Fund. Retail capital involves an entity – usually a private consumer – buying a few shares in a company through a stockbroker, as opposed to an institutional investor.

Chrystal Capital Partners is hoping to raise $100m for Verdite, which is focused for now on investing in North America but hopes later also to invest in companies in Europe, said Hadden-Paton.

He is optimistic about the sector, as the decline in retail investors has created an opportunity that wasn't there a year ago. "Now it's generally this more sophisticated investor that we're seeing who are putting the capital to work and are aware of the pitfalls of what's happened in the last few years," he said.

What This Means: Cannabis seems to be building towards a second major sector-wide cash injection. And the reasons behind it make some sense.

Cannabis was relatively unscathed by COVID – one of few consumer goods sectors that could make that claim. US legislation is looking up. Even if federal legalisation is not as close as some seem to think, it seems state positions are further solidified.

Perhaps some lessons have been learned from the previous cash dash or green gold-rush, as it was called. Certainly more sophisticated investment vehicles appear to be being utilised. But the question that remains unanswered at this point is what checks and balances have been put in place to monitor how this cash will be spent by companies.

Accusations of misspending and outright corruption ran rife the last time around. Much of the investment money disappeared, with little to show for it on current balance sheets. What is in place to prevent that happening again?

Perhaps the companies are better run and managed. Perhaps the investment funds are wiser about which to pick. Perhaps none of that is true and we will see a second pot bubble pop.

– Moriah Costa *CBD-Intel contributing writer*

Photo: US Library of Congress