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Investment Considerations for the Cannabis Industry: Spotting the Red Flags

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The recent $245-million investment by Constellation Brands, a NYSE-listed producer of beer, wine and spirits, in TSX-listed Canopy Growth focused attention across North America on the Canadian cannabis industry. The announcement of the approximately 9.9% investment on October 30, 2017 drove Canopy Growth stock up by 23%. The general updraft benefited the other four TSX-listed companies in this space and spurred recent capital market activity:

- Aphria Inc. filed a prospectus for a $92-million equity raise on November 1.
- MedReleaf Corp. announced a bought deal for a primary and secondary offering of up to $110 million on November 14.
- Aurora Cannabis announced on November 14 an unsolicited bid for CanniMed Therapeutics at a reported 74.7% premium over the 20-day VWAP.
- CanniMed Therapeutics Inc. announced on November 17 the proposed acquisition of Newstrike Resources Ltd., the TSX-V-listed parent company of a licensed producer of cannabis.

Given this recent activity and the expected legalization of recreational cannabis in Canada by July 2018, investors, underwriters and lenders who have previously shunned this industry for fear of reputational and legal risk are now giving it serious consideration. Here are the issues on which they should be focusing.

U.S. Operations or Investments: TSX Delisting Risk

On October 16, 2017, the TSX issued a staff notice warning issuers in the cannabis industry of the risk of being delisted if their ongoing business activities violate U.S. federal law regarding the cultivation, distribution or possession of cannabis. In short, due diligence must be conducted to confirm that the issuer's cannabis business does not touch the United States at all, including in states where it is legal.

Limited Financing Sources

Given the capital-intensive nature of the industry, access to financing is crucial for cannabis producers. To date, cannabis companies have had limited access to traditional bank financing and have relied on alternative financings such as "streaming" agreements and smaller public offerings or private placements of equity, without the support of the global investment banks.

Product Recalls and Product Liability Class Actions

Cannabis producers have been subject to product recalls for a variety of reasons, including product defects, such as contamination, unintended harmful side effects or interactions with other substances, such as pesticides, packaging safety and inadequate or inaccurate labelling disclosure. Recalls can lead to product liability class actions and significant reputational and financial harm to a producer. According to Health Canada, there have been nine recalls of medicinal cannabis in 2017. To date, two class action lawsuits have been publicly disclosed in respect of such product recalls.

Government Seizures of Assets

The proposed federal *Cannabis Act* will provide for robust powers of search and seizure of property that is reasonably believed to be related to contravention of the *Cannabis Act* and, in some cases, for forfeiture of such property, including land and buildings, where illegal activities are occurring. A secured party with an interest in seized or forfeited property may be able to retain its security interest if it can prove that it was not complicit in the commission of the offence and that it exercised all reasonable care to be satisfied that the property was not likely to have been used in connection with the commission of an unlawful act.

Protection of Intellectual Property in Cannabis Plants

Although patenting a plant is generally not possible in Canada, protecting newly developed strains of cannabis may be possible under the *Plant Breeders' Rights Act*. In an industry in which the ability to brand a product is limited, protection of proprietary strains of cannabis may become an important point of differentiation between producers.

Director and Officer Liability

The *Cannabis Act* will deem corporate directors, officers and agents to be parties to any non-criminal violations of the *Cannabis Act* that they authorized or acquiesced to whether or not they were actively involved in committing the offence. Although common law principles apply to the *Cannabis Act*, a due diligence defence is expressly excluded with respect to any non-criminal violations of the *Cannabis Act*. Non-criminal violations of the *Cannabis Act* include violations of restrictions on promotion, packaging and labelling and are subject to administrative monetary penalties of up to $1 million per violation.

Patchwork Provincial Regulation

With provincial governments being left to design their own systems for the distribution and sale of cannabis, the resulting patchwork of provincial regulation can be expected to raise compliance costs. Generally, provincial legislators have considered two distribution models: (i) a government-controlled monopoly, such as the models proposed by Ontario and Québec; and (ii) a hybrid model in which a government entity oversees distribution through licensed private retailers, such as the models proposed by Alberta and Manitoba.

Competition from Illicit Markets

The recreational cannabis market will remain subject to competition from the illicit market. Provincial cannabis distributors to the recreational market will need to ensure that pricing is competitive with products sold in the illicit market. Furthermore, provincial distribution will need to be conveniently accessible to consumers to compete with the broad reach of the illicit market.

Ontario and Québec Governments Monopoly over Distribution

The Ontario *Cannabis Act, 2017* and the Québec *Cannabis Regulation Act* propose a distribution model under which cannabis is distributed through a government-operated control board, similar to the way alcohol is distributed through the Liquor Control Board of Ontario. Controlled distribution and government-determined pricing may squeeze the margins of cannabis producers, making it difficult for smaller producers to compete and for all producers to compete with the illicit market.

Impact of Federal and Provincial Taxation

On November 10, the federal government announced its proposed taxation plan, which would see recreational cannabis taxed at a rate of $1 per gram or 10% of retail price, whichever is greater. Under this plan, tax revenue would be split 50/50 between the federal and provincial governments. The *Cannabis Act* leaves room for the provinces to make their own pricing and taxation decisions and Alberta and Québec have already voiced opposition to the proposed revenue split under the federal tax plan. Taxation will have a significant impact on the ultimate retail price of cannabis and the profitability of the recreational market.

Restrictions on Branding

The *Cannabis Act* will place significant restrictions on the marketing, promotion and branding of cannabis products. These restrictions will make it difficult for producers to differentiate their products, rendering price as the principal basis on which producers can compete.

Reliability of Market-Size Estimates

Estimates of market size have primarily stemmed from a 2016 Deloitte study that projects a base retail market of $4.9 to $8.7 billion annually for recreational cannabis.[1] Such estimates may not sufficiently account for the continued presence of the illicit market and overlapping demand in the medicinal and recreational markets.

Success of International Expansion

Currently, the U.S. market, the most logical international expansion opportunity for licensed producers of cannabis, is closed, forcing producers wanting scale to seek international partnerships. Many Canadian producers have already expanded into international jurisdictions where use of cannabis for medical purposes is regulated, including Germany and Australia. As regulations for cannabis use, both medicinally and recreationally, develop around the globe, international opportunities will emerge and industry participants will face the typical challenges associated with international expansion, including finding the right partners, incurring the cost of operating in a distant market and managing compliance with local laws.

Industry Capacity Constraints

Deloitte projects a required supply of over 600,000 kg of cannabis to meet anticipated demand in the recreational market.[2] By contrast, approximately 20,000 kg of medicinal cannabis were sold by licensed producers in fiscal 2016.[3] With 74 licensed producers today, the industry may be constrained to adequately service the demand for recreational cannabis, giving rise to the risk that costs may soar as producers scramble to build capacity.[4]

Export Market Limitations

Cannabis producers cannot look to the export market to grow sales for recreational use. Cannabis may be exported from Canada only for medical or scientific purposes, meaning that all recreational sales will be derived exclusively from the domestic market.

Barriers to Entry

The extensive licensing application process and high cost of establishing cannabis production facilities make entry into the cannabis market a time- and capital-intensive process. With limited traditional financing sources available, there are major barriers to entry in the cannabis industry, and established licensed producers will have a significant competitive advantage with respect to opportunities in the recreational market.

U.S. Legal Risk

Cannabis remains a Schedule 1 narcotic under the U.S. federal *Controlled Substances Act* even though 29 states have regulated cannabis use in some form.[5] Therefore, any revenue derived from cannabis-related activities in the United States would be considered proceeds of crime. Financiers of Canadian cannabis companies will need to conduct sufficient due diligence to gain comfort that the company does not derive profits from cannabis-related activities in the United States.

Conclusion

Despite these risks and the inherent uncertainty surrounding a new industry subject to evolving regulation, we see mainstream investors, lenders and underwriters taking a hard look at the opportunity. Rigorous due diligence by investors, lenders and underwriters, combined with robust compliance programs by issuers, will be required – as they always have been in other inherently risky businesses and industries – to bring the cannabis business comfortably into the investment mainstream.

[1] Deloitte, "Recreational Marijuana Insights and Opportunities" (2016), online.

[2] *Ibid.*

[3] Health Canada, "Market Data" (9 November 2017), online.

[4] Health Canada, "Authorized Licensed Producers of Cannabis for Medical Purposes" (9 November 2017), online.

[5] "29 Legal Medical Marijuana States and DC" (13 November 2017), online.

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