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Doing Deals in Cannabis: What You Need to Know!

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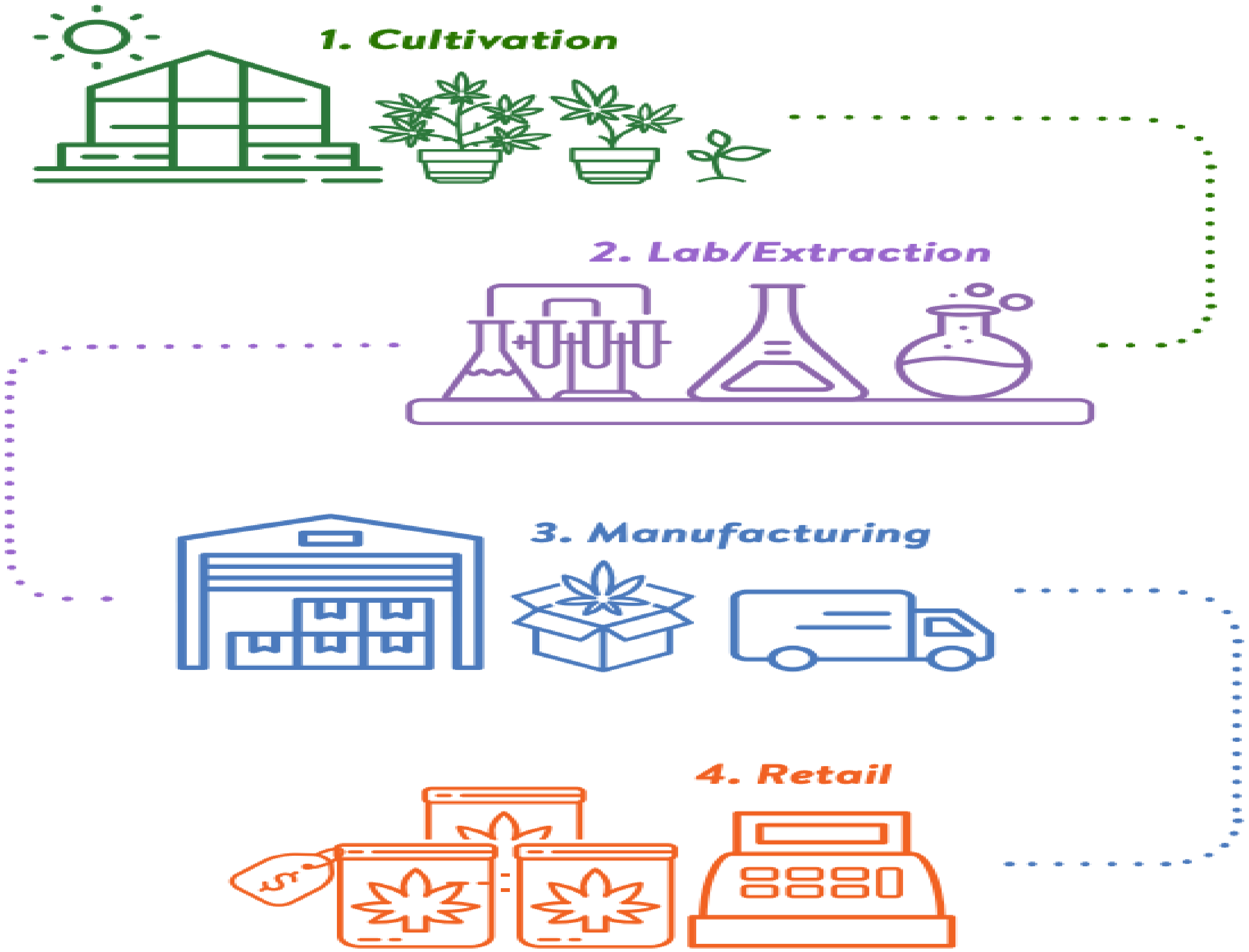
What Do Cannabis Companies Look Like

- A discussion of cannabis deals necessarily begins with an understanding of what cannabis companies can generally look like, which also speaks to the maturity stage of a company. The following provides a general overview:
- The Start-Up
  - This company is at the inception stages. This stage ranges from a license applicant, i.e., a company is formed solely for the purpose of applying for or otherwise acquiring a license, to license winners who are not yet operational.
  - State-issued licenses underpin the cannabis industry in the U.S.—note that cannabis remains an illegal Schedule I drug under the Controlled Substances Act and is therefore federally illegal. Thus, without a state-issued license a company cannot participate in the plant-touching cannabis industry.
  - Cannabis companies can exist at any stage of the supply chain. For example, in Illinois companies can hold cultivation licenses, craft grow licenses, infuser licenses, dispensary licenses, and transporter licenses.
  - Companies often strive to get the "vertical," which allows you to do everything from seed to sale. Some states, like Florida, mandate from a license holder. Other states, such as New York, prohibit it.

What do Cannabis Companies Look Like Continued

- The Single State Operator
  - A cannabis business that operates in a single state.
  - Often has a stronger focus on their local market, local employees, local culture and, most importantly, local patients and consumers.
  - A large part of the success of single-state operators can be attributed to their in-depth understanding of local customs, traditions and history.
- Multi-State Operator
  - A cannabis business that operates in multiple states.
  - While many associate multi-state operators with dispensaries, it can apply to other cannabis industry operations, as well. This includes cultivation and processing operations. The largest cannabis MSOs have vertical structures in each state that include retail and cultivation operations.
  - A cannabis MSO must find ways to establish a brand across multiple states while also creating a separate operation that adheres to each state’s laws. That includes following different sets of laws on advertising, business structure, management of facilities and compliance rules.

Vertical Integration



Deals and Transactions in the Space

- Sale and purchase of a license or an asset
  - Cannabis licenses are assets that can be purchased and sold.
  - Such a transaction almost always requires regulatory approval and certain disclosure obligations by the acquiring entity.
  - However, some states do not permit license transfer, which requires license buyers to purchase the entity holding the cannabis license.
  - Sometimes buyers only want to purchase a license, particularly in limited-license states. For example, in IL the market for buying and selling licenses is quite active despite the fact that new licenses winners don’t have physical operations.
  - In jurisdictions where there are caps on particular license types, for example there are limits on the number of dispensaries a company can own in Massachusetts, cannabis companies often sell one-off assets such as a dispensary in order to be compliant.

Deals and Transactions Continued

- Real estate deals
  - Sale/Leaseback - an agreement where an asset's seller leases the asset back from the purchaser. Immediately after sale, the seller of the asset becomes the lessee and the purchaser becomes the lessor, as defined in the leaseback agreement. This presents a great option for cannabis operators who own their real estate to quickly generate operating capital.
  - The seller usually structures the transaction for a period of 10-15 years, with options to extend. The lease period is often set for a timeframe that meets the buyers investment criteria. The viability of the investment for the buyer is based on the experience and financial strength of the seller.
  - Real Estate Investment Trusts (REIT) - typically, a REIT is a corporation that has elected to be taxed as a REIT (which provides several tax advantages, including the ability to deduct dividends from taxable income). REITs generally raise money from outside sources, often on public markets, and use those funds to buy, develop, operate, and sell income-producing properties.
  - Cannabis companies are starved for capital and exploring all avenues of raising funds. One possible way for a cannabis company to raise funds is to enter into real estate capital expansion transactions with a REIT.
  - In these deals, the REIT lends money to the cannabis company seeking to buy or build out its real estate. This transaction is mutually beneficial as the REIT makes money from the loan interest and the marijuana company can affordably finance its expansion.

Deals and Transactions Continued

- Merger & Acquisition
  - There are typically two types of acquirers: strategic and financial.
  - Strategic acquirers are other companies, often direct competitors or companies operating in adjacent industries, such that the target company would fit in nicely with the acquirer’s core business.
  - Financial buyers are institutional buyers, such as private equity firms, that are looking to own, but not directly operate the acquisition target.
  - For example, Cresco Labs, a vertically integrated multistate operator and the number one U.S. wholesaler of branded cannabis products, recently announced the closing of the Company’s previously announced acquisition of Laurel Harvest Labs, LLC (“Laurel Harvest”) Laurel Harvest is a Pennsylvania Clinical Registrant.

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From LOI to Definitive Agreement

- Most purchase/sale and M&A deals start with a Letter of Intent (LOI) or a Term Sheet.
  - These documents are typically concise and set forth the material terms of a deal.
  - An important area to focus on at this early stage of negotiating is identifying what regulatory hurdles will need to be addressed to consummate the deal.
  - Regulators have to approve the purchase or transfer of a cannabis license/cannabis company and owners of cannabis licenses usually must undergo background checks. Deal partners should prepare for a sluggish timeline.
- Once an LOI has been executed you will generally move on to drafting and preparing definitive documents (Stock/Unit Purchase Agreements, Asset Purchase Agreements, Management Service Agreements, etc.).
  - Regulatory due diligence and proper drafting of closing contingencies are crucial.
  - Cannabis licenses are often tied to property. Real estate diligence is paramount.
  - Proper tax diligence is also vital given the onerous implications of 280e.
  - Understanding state regulations, and cannabis business operations will help you identify red flags.
  - Often data rooms will include a lot of information lawyers may not be used to seeing. Particularly in cultivation deals (room/racking layout, lighting design, yield metrics etc.). Familiarize yourself with industry standards and expectations.

Deals and Transactions Continued

- **Going Public**
  - An initial public offering (IPO) is when a previously privately held company sells shares to the public for the first time to either raise capital or broaden its base of investors. After the IPO, the newly minted shares of stock become available on an exchange. Investors can buy and sell the shares as they would any other publicly traded stock.
  - One of the biggest reasons cannabis companies will try to go public is to increase its access to capital markets through the sale of its shares of common stock to the public. Most often, mature single state operators and multi-state operators are looking to go public.
  - Due to federal illegality, U.S. plant-touching entities have generally been prohibited from trading on Nasdaq or the NYSE.
  - Conversely, non-U.S. cannabis companies in full compliance with all applicable jurisdictional laws have not faced the same scrutiny, explaining why companies such as Tilray have enjoyed largely unfettered trading on Nasdaq.
  - Exchanges have been less certain about whether or not to prohibit the listing of cannabis "ancillary" companies, which aim to acquire non-plant-touching companies within the industry, including companies engaging in technology, professional services, and equipment/storage.
  - These stringent requirements pose a major problem for American cannabis companies. The hurdles, coupled with continued legal restrictions, involved in listing on major U.S. exchanges are forcing more U.S.-based cannabis companies to consider going to Canadian exchanges instead.

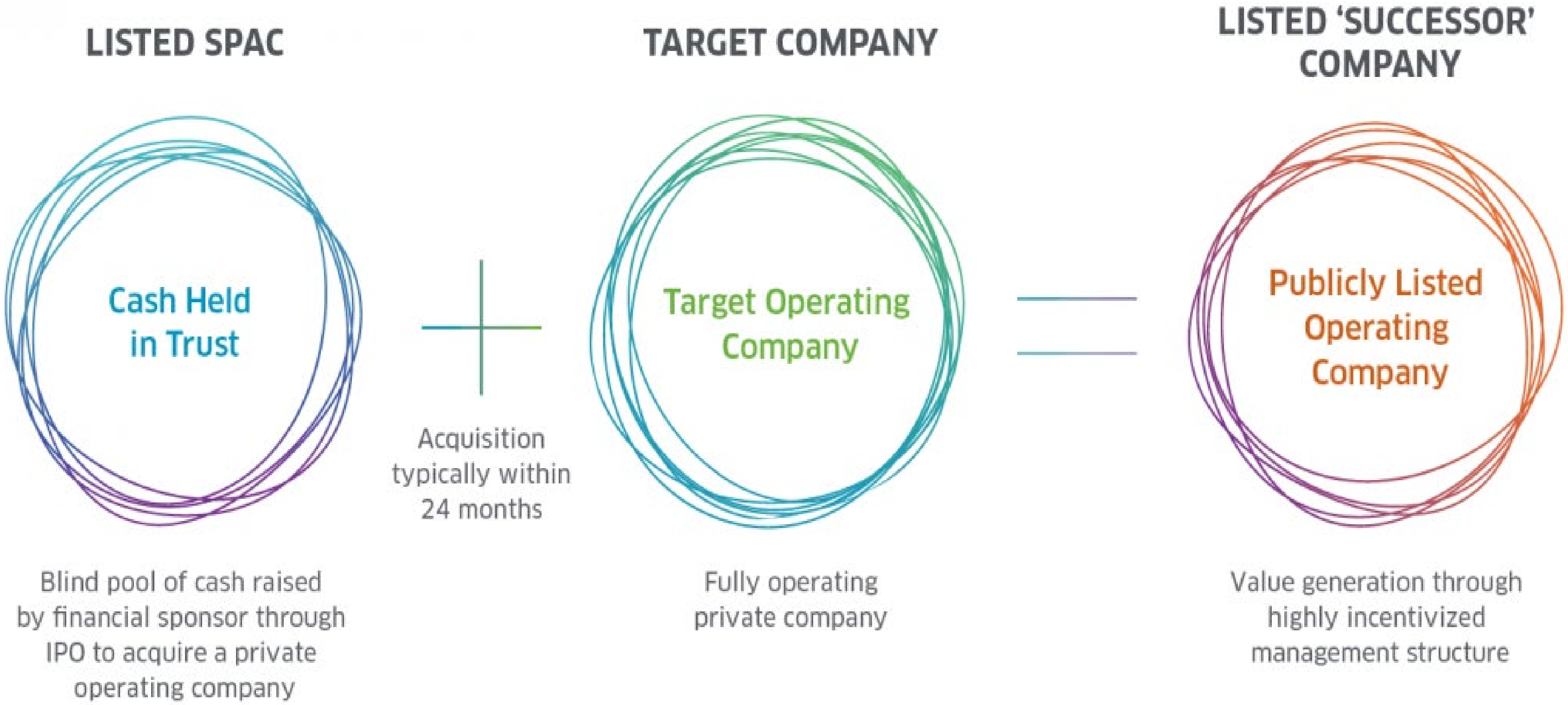
Deals and Transactions Continued

- SPACS
  - With the evolving nature of cannabis legality in U.S. jurisdictions and the push towards federal legalization, some entrepreneurs in the cannabis space are considering SPACs as an early means of entry into the capital markets.
  - Rather than go through an initial public offering (IPO), investors and cannabis companies increasingly turn to special purpose acquisition companies (SPACs) to enter the public market.
  - Sometimes known as "blank check companies" SPACs are typically formed by a private equity sponsor that lists its common equities on a public stock exchange through an IPO, with the eventual goal of combining with private businesses.
  - This creates a "back door" into the public markets since these private enterprises don't need to go through the expense and hassle of their own IPO.

Going public in Canada and the use of SPACs

- Due to long-standing federal prohibitions on the production and sale of cannabis and cannabis-related products, the industry is regarded as capital starved. Cannabis industry observers project that the industry has incredible growth potential. These two factors make cannabis companies attractive targets for SPACs.
- A SPAC is an “empty-shell” publicly-traded company that raises capital through an initial public offering. The SPAC then identifies and uses the investments to negotiate with and purchase a privately-held company to bring the privately-held company to the public market to fill the shell of the SPAC.
- Upon the SPAC’s completion of the acquisition of the privately-held company (referred to as a “de-SPAC transaction”), the SPAC’s investors typically have the option to swap their SPAC shares for shares of the newly merged public company, or redeem their SPAC shares to recoup their original investment plus interest.
- There has been a significant and well-publicized increase in SPAC IPO transactions in 2020 and 2021. SPACs have attracted companies in industries that struggled to raise capital through traditional means or those that may not be willing to engage in the lengthier and costlier IPO process.

How Does a SPAC Work?



Notable 2020-2021 Cannabis Deals

2020

- Before the coronavirus pandemic, Cresco Labs officially closed its acquisition of Canada-based cannabis company Origin House. Perhaps the biggest cannabis transaction in the year, the move paved the way for Cresco Labs' entry into the United States' largest cannabis market: California.
- Multi-state, vertically integrated cannabis company Columbia Care closed its transaction with The Green Solution, one of Colorado's largest vertically integrated operators, in September, bringing Columbia Care's footprint to 95 facilities open or under development in the United States and European Union.
- In late July of 2020, Curaleaf closed an approximately $700-million deal to acquire Grassroots Cannabis. The move places Curaleaf boots on the ground in 23 U.S. states with a footprint that includes 88 operational dispensaries and 22 cultivation sites with 1.6 million square feet of current cultivation capacity.

2021

- Ayr Wellness Inc., a vertically-integrated cannabis multi-state operator (MSO), recently entered into a definitive agreement to acquire Herbal Remedies Dispensaries, LLC ("Herbal"), an operator of two licensed retail dispensaries in Illinois, adding an eighth state to its expanding national footprint.
- Cresco Labs co-founder and former president Joe Caltabiano launched a SPAC (special purpose acquisition corporation) aimed at purchasing cannabis companies in the U.S., Canada or international markets. Choice Consolidation Corp., a new cannabis industry special purpose acquisition company (SPAC), raised $150 million in an initial public offering on the Canadian NEO Exchange.
- Florida-based cannabis multi-state operator Trulieve Cannabis Corp. completed its acquisition of Harvest Health & Recreation Inc.

Investor Entry Points

- Public Company
  - For example, Cresco Labs, Inc. is a publically traded vertically integrated cannabis company based in Chicago, IL.
  - Investors can invest in large publically traded companies.
  - There are also cannabis Exchange-traded funds like Amplify Seymour through which an investor can participate in multiple public cannabis companies.
- Mature Private Company
  - For example, Viola, a company founded by retired NBA player Al Harrington. Currently, Viola is available in stores across Colorado, California, Michigan and Oregon.
  - Investors can invest in mature private companies, particularly when the private company is looking to expand or bring a new product to market.
- Start-Up
  - Often the most risky investment – investors can invest in newly licensed cannabis businesses.
- Ancillary Canna-business
  - Businesses like Leafly, Weed maps and Aryoa.
  - Many of these ancillary businesses are still privately held and often looking for capital investment to expand their reach. These investments don’t have the same risk associated with plant touching businesses.

Standard Documents

- Convertible Notes
  - A convertible note is a type of short-term debt financing that's used in early-stage capital raises. In other words, convertible notes are loans to early-stage startups from investors who are expecting to be paid back when their note comes due. But, instead of being paid back in principal with interest—as would be the case with a typical loan—the investor can be repaid in equity of the company.
- Equity Purchase Agreements
  - An equity purchase agreement is an agreement to sell the equity shares of the company to the purchaser. Equity purchase agreement results in the transfer of equity shares of the company along with the transfer of the ownership and liabilities of the company (disclosed and undisclosed) proportionate to the equity shares transferred to the buyer.
- Private Placement Memorandums & Subscription Agreements
  - A private placement memorandum (PPM) is a document given to potential investors that introduces an investment and discloses information about it. The PPM is part of a securities offering process called private placement.
  - A subscription agreement is a formal agreement between a company and an investor to buy shares of a company at an agreed-upon price. The subscription agreement contains all the required details. It is used to keep track of outstanding shares and share ownership (who owns what and how much) and mitigate any potential legal disputes in the future regarding share payout.

Regulatory Concerns in the Deal Context

- As previewed earlier, having a fulsome picture of the regulatory constraints and issues related to a cannabis transactions is imperative.
  - Get an understanding of the timetable for the entire deal and how long approval could take. Up to a year for approval is not unusual in some jurisdictions.
  - Consider constraints on particular licenses, including social equity status, license caps, timing restrictions on when licenses can be moved or sold, vertical integration restrictions etc.
  - What implications are triggered and what are the workarounds?
  - What documents and information do the parties need to prepare to disclose to the regulators? Cannabis disclosures can be more invasive than investors are generally used to.
  - Due diligence on the licenses and assets:
    - Are the licenses in compliance, when are fees due and when and who will be responsible for those?
    - Is the real estate in compliance?

How the cannabis deal space has evolved

- As the cannabis industry evolves and matures so have the deals.
- For example, in 2018 companies were being valued and evaluated based on the number of licenses they had, and this was really the time MSOs emerged.
  - This metric wasn't necessarily the best as a lot of the licenses were not operational, but because of their limited nature in most states, they were the driver of how companies were evaluated.
- In 2019 we saw several major companies go public at massive valuations. We also saw the Department of Justice get involved and evaluate several proposed mergers for antitrust implications, including 4front ventures, and Verano/Harvest merger.
- 2020 saw the rise of SPACs and second tier cannabis companies (smaller MSOs) made moves to grow operations.
- 2021 is closing on a bit of an lull. Publically traded companies have taken a hit on their stock prices, investor dollars have tightened as investors have become more savvy about investing in private cannabis companies and their valuations, and even profitable privately held companies are having trouble finding buyers.

Predictions for the Future

- Federal legalization predictions and implications
  - In 2022, we expect to see at least one piece of meaningful federal legislation passed. Reform will likely come in the way of banking, decriminalization, or legalization.
  - States with existing legal cannabis programs may begin to try and normalize regulations across state borders and prepare for interstate commerce.
  - Interstate commerce will lead to the emergence of genuinely national brands but could pose enormous risks for boutique and cottage operators.
  - On the other side, those small boutique, and equity operators could have the opportunity to reach fans of their brands across state lines.
  - Federal legislation will likely compress the market, creating more competition and increase the tax burden on cannabis companies.

Thank You

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