Insights Gained from Performing Cannabis Industry Valuations in the United States

The cannabis industry is experiencing unparalleled growth due to the confluence of several interrelated factors, including a dramatic shift in public opinion, the emergence of state-sponsored regulatory and legal frameworks, and the recognition by the business community of the vast potential of consumer products and commercial uses of the plant. This advent of cannabis as a viable and robust industry has created the need for supportable and objective valuations.

This article is based on lessons learned from performing dozens of valuations in the cannabis industry for purposes of corporate roll-ups, spinouts, transactions, employee stock option plans, and litigation.

Rendering a supportable valuation opinion in the cannabis industry, especially in the United States, is uniquely challenging. The appraiser must navigate and comprehend a highly fragmented and fluid regulatory and legal framework; complex tax and banking issues; a dearth of empirical data; a disconnect between market driven valuation multiples and traditional methods of pricing risk; and a myriad of operational obstacles. Cannabis operators face arduous regulations and discordant banking issues and must manage risks related to running essentially a cash business in a capital-intensive industry with fierce competition and underlying commodity pricing issues.

A significant change in the public's perception of cannabis led to a wave of cannabis legalization at the state level – 33 states have approved either medical and/or recreational use of cannabis. Along with the reshaping of state and local marijuana laws, the business community became aware of the huge economic potential of cannabis. Cannabis is unique in its breadth of potential consumer products and applications covering recreational, wellness, nutraceutical, pharmaceutical, and industrial markets. Today, cannabis is a multi-faceted industry with a vast array of consumer products. The diversity of products has fueled the development of a wide range of businesses and operations looking to capitalize on the booming industry.

Those looking to create value from the booming industry have also benefited from continued federal prohibition under the Controlled Substances Act, which has mostly prevented well capitalized global corporations from entering and dominating the industry. This has allowed primarily small businesses to establish themselves as market leaders in the cultivation, processing, manufacturing, distribution, branding and selling of cannabis related products in the United States.

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A "land grab" is underway where companies are quickly acquiring assets to access capital markets (in an IPO, private placement or other capital infusion) or to be first-in-line when industry consolidation via the entrance of large corporations inevitably occurs. The pace of asset acquisitions has led to a strong demand for valuation services.

Regulatory Framework

State-sponsored legalization efforts have resulted in a complex and ever-changing web of regulations and laws facing owners, operators, investors and almost all industry stakeholders. Understanding the landscape is pivotal to arriving at a supportable valuation in the cannabis industry.

Cannabis law and regulations vary from state to state, and in many cases, municipality to municipality. As a starting point, there are stark differences in both the type and availability of cannabis licenses between jurisdictions. The applicable regulatory framework will impact the value of said licenses. Companies holding licenses in states with highly regulated programs – primarily medical-only states – will often earn the greatest value premium from the market as limited licenses and reduced competition typically produce greater economic benefits. Conversely, operators in states with unlimited licenses, such as Oregon, are not likely to experience the same value from either the license or operations. In addition to the number of licenses, there are significant differences in the types of licenses available and this too varies by jurisdiction.

A common method used when valuing a cannabis company is the discounted cash flow ("DCF") method under the income approach. A DCF relies on using projections of the company's future performance and the present value of expected cash flows to calculate value using a risk adjusted rate of return. The appraiser must evaluate and critically examine the projections provided by management to ensure the forecast is supportable and reasonable. This requires a knowledge of the regulatory framework that directly impacts the expected economics and operational performance of the company. When evaluating expected revenues, questions arise, such as do they make sense given the competitive environment and market size? Are the projections consistent with the regulatory environment?

Understanding the regulatory framework is also critical when applying the market approach. The market approach is based on the principle that in a free market, supply and demand factors will converge at price equilibrium and that a prudent investor will pay no more for the subject asset than the prevailing price for an asset of like utility. The market approach arrives at an indication of value for a subject company by using one or more methods that compare the risk and return characteristics of similar investments that have been contemporaneously priced in the marketplace, either through sale of a comparable company or pricing of a comparable company's securities. The proper application of the market approach requires identifying comparable companies and transactions to the subject company.

Finally, it's critical to understand how regulations are changing in real time. As states contend with lawsuits, shifting political priorities, and popular opinion, the cannabis regulations are in a constant state of flux. A valuation based on a regulatory snapshot today may be quickly out-of-date as states and municipalities adopt and change their regulatory frameworks. Subscription services like CannaRegs can help by tracking state and local regulations, but the appraiser must take responsibility to understand the applicable regulations as of the date of value.

Financial Benchmarking

Financial benchmarking is critical to a supportable valuation, as it allows a meaningful comparison of a company's historical and projected performance to known industry economics. When evaluating projections and business plans, benchmarking provides a reasonableness check. Industry data is especially useful when relying on a DCF analysis to value an early-stage company.

Financial benchmarking is challenging in the cannabis industry due to a scarcity of empirical data. Companies in the industry are experiencing tremendous growth and as often is the case with high growth companies, a DCF analysis is especially useful. In addition to the normal assumptions contained in a set of financial projections for use in a DCF, cannabis companies with cultivation operations must also project yields, turns and workflow schedules. Without reliable industry empirical data, it is nearly impossible to stress test or "sanity-check" management's forecasted operations. There are ways to mitigate this challenge, primarily by researching general information regarding cannabis operations and reviewing publicly traded companies' public filings. While these avenues can provide useful data, they are rarely suitable replacements for data that is derived from actual operating companies of similar size and operations.

One benefit of performing a significant number of appraisals in the cannabis industry is the aggregation of operating and financial data from actual operating companies. Collecting data from dozens of cannabis companies, from cultivation to branding, allows for proper financial benchmarking to determine if management's projections are supportable.

Market Pricing and Risk Assessment

There are multiple approaches and methods to arrive at an indication of value of a business, ownership interest, security or asset. Ideally, the indications of value under different methods are consistent with each other.

Without getting too far into the weeds, the market approach and income approach are doing the same thing; namely, arriving at an indication of value by applying measures of risk and growth to an economic benefit (e.g., EBITDA, cash flow, etc.). The market approach may rely on an observed multiple of EBITDA to arrive at an indication of value (e.g., 8X EBITDA) while a DCF will discount future cash flows at a risk adjusted rate of return (discount rate). A multiple is the inverse of a capitalization rate. A capitalization rate is equal to a discount rate less long-term growth. In other words, the application of a multiple to an economic benefit is the same thing as dividing that economic benefit by a capitalization rate. All this to say that the market approach and income approach both essentially rely on a risk adjusted capitalization rate (expressed as a multiple under the market approach) to arrive at a measure of value. For the market approach, the higher the multiple, the lower the implied capitalization rate.

The challenge with cannabis companies is that there is a tension between the observed market multiples (market approach) and the output from the customary discount rate models under the income approach. Cannabis companies are currently trading at very high multiples due to assumed growth trends, assumptions about future federal legalization and access to cheaper sources of capital, limited investment vehicles, demand for cannabis assets and current investor dynamics. High multiples imply either lower risk or higher growth or a combination of both. When determining a risk adjusted discount rate under traditional methods, the rates are often higher than what is implied by the observed market multiples. This creates a potential inconsistency between the market approach and income approach in the implied assessment of risk. A reconciliation between approaches is possible, but it requires careful consideration and analysis.

The key issues to consider include the comparability of the guideline companies and transactions and the applicability of observed market driven valuation metrics, expected growth assumptions, and most importantly, the actual risk profile of the subject company. Operating in the cannabis industry does not necessarily make the company significantly riskier than companies operating in other industries. Yes, there are specific and unique risks and challenges facing companies in this space, but it is essential to perform a detailed assessment of the aggregate factors and characteristics of the subject company, including assets, business plan, applicable regulatory framework, and perhaps most importantly, management.

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Human Capital

As with all companies, the importance of the human capital element cannot be overstated. The management team is critical to the success of any enterprise and this is especially true with cannabis companies, given the number of challenges and complexities involved. In my experience, this critical factor is often overlooked or minimized in the appraisal of companies in this industry. Business plans, assets, projections and investor pitch decks describe the opportunities and vision of an enterprise, but it is up to management to execute. This is especially true for early-stage companies.

An appraiser must carefully consider if the management team has the experience, knowledge and capabilities to execute successfully, whether it be cultivation, retail, distribution or licensing. Does management have a proven track record and an understanding of the complexities and challenges they must overcome to be a successful company?

The cannabis industry is rapidly growing and evolving. The act of performing a valuation requires specialized knowledge, access to empirical data and, most importantly, a commitment to research and analysis, especially regarding the applicable legal and regulatory framework. Opportunities to capitalize on the expected growth of the industry is driving significant M&A activity and, perhaps not surprisingly, related litigation. Valuation is often at the center of both and it is critical that decision makers are relying on supportable and objective indications of value.

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