Cassels

Canada vs. USA: Cross-Border Challenges in Cannabis

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Cannabis is arguably one of the most talked about – but turbulent – markets in recent times.

Although there are rumblings on the cannabis market throughout the world, it is without doubt that Canada and the US are the focus of investor attention.

Top of mind for investors is the potential passage of US federal law, making it "open season" for expansion of the recreational and medical markets. Until then, in the US, there is significant future uncertainty burdening this fascinating but falteringly fragmented sector.

Notwithstanding the apparent slowing in the North American cannabis markets reported of late, the US journey has been groundbreaking. California passed the *Compassionate Use Act* back in 1996, effectively legalizing medical cannabis. Fast forward to today, 33 states have legalized medical cannabis at some level and 11 states (and Washington DC) have legalized both uses.

Meanwhile, Canada saw a late start. Health Canada established the "*Marijuana for Medical Purposes Regulations*" in July 2001, permitting certain patients access to medical cannabis. A shot in the arm came from the legal crescendo north of the border on October 17, 2018 and made cannabis federally legal.

By this time, some licensed producers, pharmaceutical and medical research companies such as Aurora Cannabis, Inc. had already completed public listings on the Toronto (TSX) and Canadian Stock Exchanges (CSE).

Things have been a little more complex for US cannabis operators seeking to access the public markets…

Double Standards

The more relaxed legislative environment in Canada meant that the first and highest volume of IPOs have been on its exchanges, with the likes of Aurora Cannabis Inc. (Canada), Canopy Growth Corporation (Canada), Tilray, Inc. (Canada), Cronos Group, Inc. (Canada), GW Pharmaceuticals plc (UK) and HEXO Corp (Canada) all making their public debuts on the TSX or CSE.

Particularly interesting is that listing on just one exchange wasn't enough, especially where access to US return-hungry investors was concerned. This saw Canadian-based players "double-dipping" by listing on both a Canadian and U.S. exchange which provided them a capital-injected-springboard and helped the legal cannabis market in Canada outpace the US – not just by the benefit of greater trading freedoms, but from access to two pools of public capital.

A successful listing on NASDAQ or NYSE also means status. Being able to sit beside other established companies could lead to further validation from equity analyst reports, increased investment, and greater stock liquidity – factors not usually associated with alternative exchanges.

Of course, the solution for some US cannabis companies seeking public listings is the reverse of their Canadian counterparts: to list in Canada. Trulieve Cannabis Corp., Curaleaf Holdings, Inc., Cresco Labs Inc., Acreage Holdings, Inc., and MedMen Enterprises, Inc. are all US based operators listed on the CSE.

Naturally, Canada's head start allowed for faster growth while most US operators that could not get a CSE listing relied on capital from private equity sources while being hindered by stringent banking restrictions, though some sought an alternative exchange.

A number of the mid-market US cannabis operators are listed on the Over-the-Counter exchanges (OTC). OTC has fewer listing, reporting and regulatory requirements compared to NASDAQ or NYSE, which both prohibit 'plant-touching' US cannabis stocks. Some financial institutions decline to invest in OTC traded stocks which in turn limits trading volumes, positive coverage and may even create 'stigma' around cannabis stocks. However OTC still remains an alternative, legal source of capital, public company status and positioning for potential "up listing."

Among those listed on the OTC is MedMen Enterprises and KushCo Holdings. These are by no means small players – each had respective revenues of $130 million and $149 million for the last twelve months, according to S&P's Capital IQ.

Cross-Border Positioning and CBD

While US listing restrictions prevent a US *cannabis* grower or producer from undertaking an IPO on the more rigorous NASDAQ or NYSE, there is a grey area when it comes to a pure-play, hemp-derived CBD operator. With the passage of the Farm Bill and the explosion of the CBD market (CBD is also a derivative of cannabis but is reportedly non-psychoactive, unlike THC).

If the FDA further clarify policy and regulation in 2020, will this be the next wave of public listings for US companies, or will CBD companies remain a prohibited stock in the same way current US cannabis stocks are?

Perhaps the 'giants' of the Canadian markets are preparing for mass acquisition of CBD and hemp related operators to give them a firm foothold in the US market which can then quickly be converted to, or duallyoperated as, a cannabis operation.

M&A activity across the borders initially was driven by the relative infancy and ponderous US market which meant lower-valued companies and Canadian acquirers looking to capitalize before the potential US federal legalization added another few ‘x’ to each deal.

BNN Bloomberg reported that over 20 additional acquisitions of US companies were made by Canadian cannabis companies in the first three quarters of 2018 versus 2017. In September 2019, the Cannabis Business Times reported it expects this activity to continue.

Of late, it seems behaviors are changing with the softer market and M&A activity will be more about strategic alliance rather than land-grabbing. With the restrictions in place in the US and current operational challenges faced, US companies are likely to continue to seek capital from Canada, but this may be in the form of stock-for-stock transactions in the future as opposed to cash.

Selective Acquisition Opportunities Ahead?

As the smoke clears away, the signs of a slowdown and consolidation are appearing, and the data certainly supports this trend.

MBD reported that 25 of the M&A deals in the nine months to September 30, 2019, were in the private sector which could be a sign of consolidation of smaller participants.

Data obtained from S&P’s Capital IQ shows that 42 publicly listed cannabis companies (as monitored in NCV’s Global Cannabis Index) have a combined market capitalization of $32 billion. And yet, in the last 12 months, generated just $3.7 billion in revenues and incurred $1.7 billion (almost half) of *negative* EBITDA. This is an average valuation of 8.6x revenues – something usually only seen in tech companies. It’s hard to believe valuations like this are realistic, especially when only 10 of those companies generated positive EBITDA in the same period for a total of $272 million.

While there may be a calming in spending, less access to capital and correction in value, not all is lost for this exciting sector. New Frontier Data (NFD) estimates that legal US cannabis sales will grow to $29.7 billion by 2025 which, if it materializes, may justify the valuations mentioned above, but this is not likely to be without some casualties.

There has been a flurry of IPO and capital activity in the early years of this industry and now there are multiple indicators of a slowdown.

The growers and producers in the US have cash hungry business models which require high operational and capital investment to survive. But there is a lack of available capital from the US markets for even some of the US operators listed in Canada.

An interesting time of consolidation may be upon us as we look ahead to 2020 but with stock-for-stock deal structures and deferred cash mechanisms.

Either way, stronger operators in the US and Canada with established supply chains, scalable and vertically integrated models will reap the value opportunities ahead in the form of cross-border collaboration and M&A activity which may be fueled partly with alternative capital from associated sectors, as already seen from beverage and tobacco giants Constellation Brands and Altria.

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