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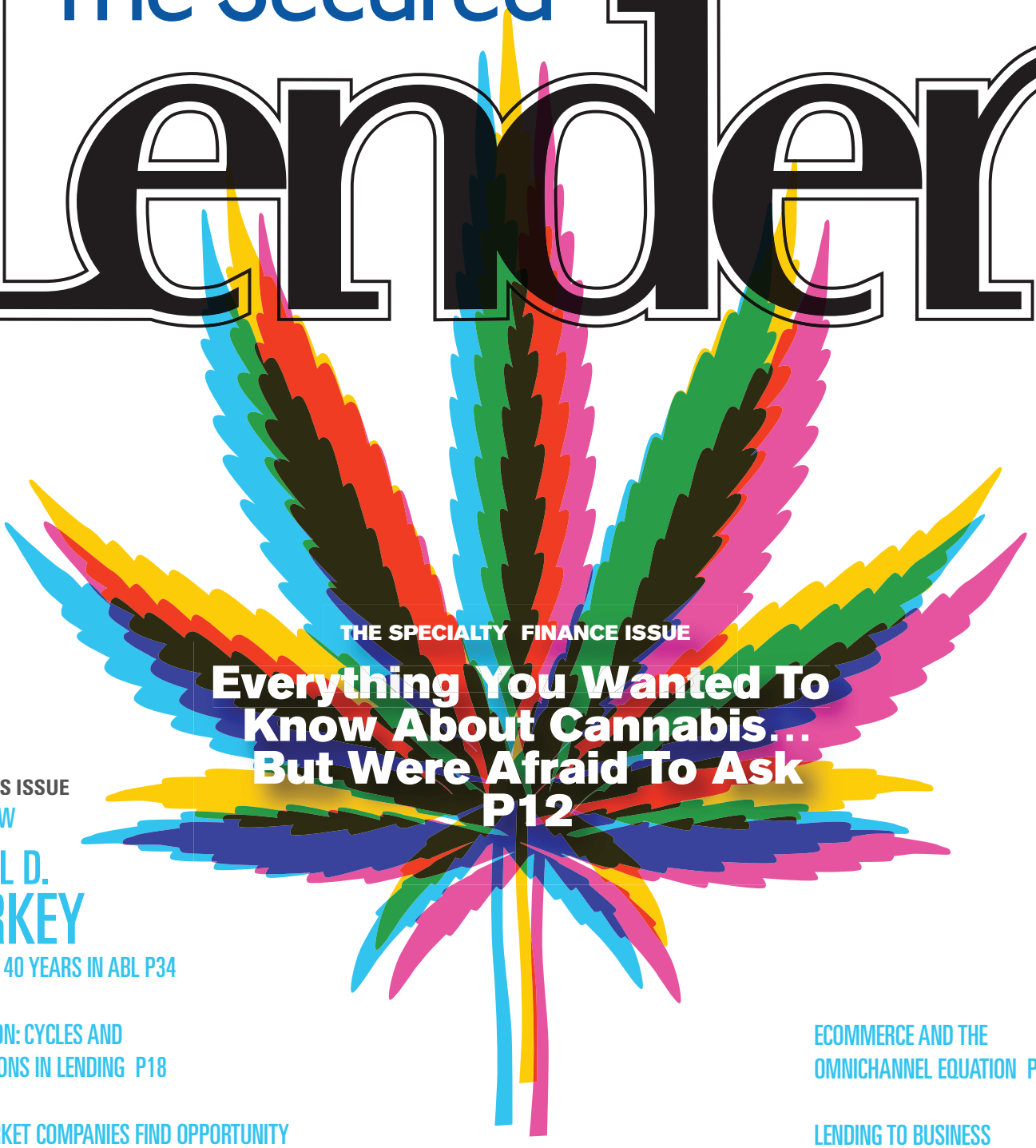

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Everything You Wanted To Know About Cannabis... But Were Afraid To Ask.

By Myra Thomas

Money-laundering statutes, restrictive banking regulations and the stigma surrounding the cannabis industry have caused established banks and well-known independent secured lenders to stay clear, but the possibility of new regulations may ease their fears.

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It goes without saying that most businesses are dependent on outside financing. However, when it comes to states where marijuana is legal, it's still a federal crime to finance the companies involved in this new and ever-growing industry. The Controlled Substance Act of 1970 listed cannabis as a "Schedule 1 substance", making it subject to federal criminal prosecution due to its "potential for abuse." It's a category that also includes ecstasy, heroin and LSD. Money-laundering statutes, restrictive banking regulations and other federal laws apply to any lender that might look to fund a marijuana operation, recreational or medicinal in nature. Not surprisingly, established banks and well-known independent secured lenders have stayed away from the industry.

The stigma of the drug also presents a problem for asset-based lenders and factors that are generally conservative in nature.

The specter of federal law enforcement and remaining concerns about the drug's use hasn't stopped some funders from investing in and lending to U.S. marijuana dispensaries, growers, commercial properties for the industry, agricultural technology companies, consumption device firms, various types of equipment manufacturers, and many other cannabis-related businesses across the country. They see the profit to be made, and many are taking the long view that recreational and medicinal marijuana will eventually be legal on the federal level. Viridian Capital Advisors reports that investment capital raised by cannabis companies across the globe more than quadrupled to $14 billion in 2018, driven by legalization in Canada and a growing number of states in the U.S. legalizing marijuana for medicinal and recreational use.

Financing Cannabis

According to Robert Cohen, a partner at Moritt Hock & Hamroff LLP, the issue for many lenders is whether or not a lender's conduct runs afoul of the money laundering laws. Although its applicability to a particular company may vary based upon the relevant laws and specific facts, money laundering is generally defined as a financial transaction with proceeds from an unlawful activity with intent to promote the carrying on of the unlawful activity. Cohen further notes that established lenders are also concerned with the lingering stigma that may come with conducting business in the cannabis industry.

Nonetheless, there appears to be a small number of startup secured lenders and lessors in the space. With potential changes in cannabis laws being discussed nationwide, Cohen says he could eventually see secured lenders acting as "trailblazers" for participants in the industry. Thus far, he has seen most of the financing coming from private money. It also appears that a small number of state-chartered banks and credit unions are starting to open their doors to cannabis-related companies.

Early-stage companies tend to find financing from friends and family, notes Andrew Lines, principal at CohnReznick. "Some often mortgage other businesses for start-up cash, application fees and soft cost," he adds. As these businesses start to scale, they face more limited roads—usually via public filing in Canada, M&A with existing multi-state operators, sale-leasebacks with REITs, if they own their own real estate, or private equity. "There are very few asset-based lenders, but there is some private debt available," he adds. But Lines does believe that the money in the adult-use market will eventually be too lucrative for lenders to pass up.

Crushing the Stigma

Even with the threat of federal prosecution looming, the U.S. Treasury's Financial Crimes Enforcement Network reported that 633 financial institutions (small banks and credit unions) were already doing business with marijuana-related businesses at the end of the 1st quarter of 2019 vs. 411 in the 1st quarter of 2018. The transactions relate to a variety of banking services. Industry insiders note the figures do not accurately represent the number of financial institutions servicing the industry and that the figure, while consistently growing, is considerably lower. Despite the dispute on the numbers, an increase in the number of financial institutions working with the industry does appear to indicate that some of the stigma once associated with marijuana use is slowly and surely going up in smoke.

Simply put, there is considerable money to be made in recreational and medical marijuana sales, as well as in producing hemp-based CBD products, and that is drawing smaller banks and investors into the space. According to "The State of Legal Cannabis Markets" report produced by Arcview Market Research and BDS Analytics, total legal cannabis spending in regulated dispensaries in the U.S. exceeded $9.8 billion in 2018 and is predicted to hit $30 billion in 2024. Arcview Group estimates that sales of CBD-based products in all 50 states will total $20 billion by 2024.

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The prospect of big money is also drawing large and well-known companies in other industries to buy into Canadian companies where marijuana is legal. For instance, Marlboro producer Altria recently bought into Cronos Group and Corona brewer Constellation Brands recently bought into Canopy Growth. Company listings and ETFs on the NYSE and NASDAQ continue to grow and draw attention to a number of cannabis businesses in the U.S. and Canada. The tide is also turning regarding public sentiment, and many assume that federal laws will eventually need to follow suit.

The Current Landscape

Today, Alaska, California, Colorado, Illinois, Maine, Massachusetts, Michigan, Nevada, Oregon, Vermont and Washington, in addition to the District of Columbia and several territories, have legalized recreational use. More states are expected to make a similar move, given the revenue generated. Medicinal use is approved in 33 states and the District of Columbia. In total, 47 states have approved the use of cannabis in some form. And, this past year, Canada followed Uruguay's lead to become the second country to legalize recreational marijuana. Uruguay approved recreational use in 2013.

Bank of Montreal (BMO), one of the biggest banks in Canada, is taking a strong lead by financing cannabis companies. And, in the U.S., a growing number of major industry analysts have initiated coverage of all things cannabis-related. "When you start to see industry coverage, from the big banks and investment firms, which there are, it's a signal," says Debra Borchardt, co-founder and CEO of *Green Market Report*. "It's their way of signaling that they're going to be in the business when the time comes. They're getting people used to the idea." It takes time, she notes, and this is the beginning of change.

There's movement on other fronts as well. As of April, the U.S. Food and Drug Administration had approved several cannabis-based drugs, including a seizure medication called Epidiolex, containing a purified form of CBD. Marinol and Syndros were also approved for the treatment of cachexia related to weight loss in AIDS and cancer patients. Both drugs consist almost entirely of THC or the psychoactive part of cannabis. Another FDA-approved drug, Cesamet, contains a synthetically produced THC-like component, and is used to ease nausea and vomiting after chemotherapy.

Despite the changes afoot, established banks and well-known secured lenders continue to note that the legal and reputational risk remains too great to finance cannabis companies. However, Aaron Smith, executive director of the National Cannabis Industry Association (NCIA) says there are "innovators" stepping in to fill the gaps created by onerous federal policies and the continuing stigma they create for the cannabis industry in the financial sector. He adds, "There are boutique firms that specialize in offering services to the cannabis industry in underserved fields and areas that are popping up all the time, and many of them are earning an excellent reputation in the industry." When there's money to be made, entrepreneurs, whether funders or cannabis-related companies, are sure to capitalize on the market high.

How to Underwrite

But given the current landscape, it can be difficult to determine which funder or cannabis company is the most reputable. The borrower needs to do homework on the lender, and

THE 411 ON MARIJUANA VS. HEMP

Cannabis has two primary species—hemp and marijuana. Both hemp and marijuana produce many of the same cannabinoid compounds, but in very different amounts and profiles. Marijuana contains tetrahydrocannabinol ("THC"), the intoxicating cannabinoid. Unlike marijuana, hemp does not produce large amounts of THC. Hemp, like marijuana, is capable of producing cannabidiol or CBD, which is used as a relatively new natural remedy as an isolated compound. It contains low amounts of THC. Hemp plants have also served a variety of purposes for many years—plant stems for fiber, seeds into protein, or leaves and flowers for oils and other products. Hemp fibers are made into paper, clothing, furnishing fabric, rope, and building materials.

According to Samantha Barbere, an attorney at Moritt Hock & Hamroff LLP, the Agriculture Improvement Act of 2018 (commonly known as the 2018 Farm Bill) legalized hemp at the federal level. Hemp, which for decades was classified as a Schedule I controlled substance under the Controlled Substance Act, is derived from the cannabis plant. As per the Farm Bill, hemp must contain a THC concentration of not more than 0.3 percent on a dry-weight basis. Cannabis plants containing more than 0.3 percent THC would be regarded as non-hemp cannabis (or marijuana) under federal law and would not be afforded legal protection under this new legislation. Pursuant to the Farm Bill, the U.S. Department of Agriculture (USDA) must construct a federally run regulatory program, under which hemp cultivators can operate and apply for licenses. The USDA aims to have regulations issued by the fall of 2019 in order to accommodate the 2020 planting season. Barbere notes that the applicability of the Farm Bill to any particular situation requires a more formal analysis.

that may not even be possible or feasible. Given the limited options for capital available to cannabis businesses, particularly smaller ones, Smith says that many of these companies are more than willing to take on "additional risk by working with relatively unknown lenders simply to survive and maintain viability." The cost of capital is another industry concern.

Funders too are tasked with doing due diligence on cannabis companies in an uncharted and heavily regulated industry. The state of Colorado, for example, has prohibited security interests in state-licensed entities, which might be where a cannabis company's assets are held. Dean Landis of Kind Growth Capital (KGC), notes, "Kind Growth Capital typically lends to non-licensed entities in Colorado—a state where we have a large presence." A good deal of the lending is in the form of real estate-related loans rather than traditional ABL, he adds. Given the nature of cannabis businesses and the laws and regulations they face, Landis says that traditional asset-based lending transactions generally don't work. Simply put, there may not be sizable receivables that are paid for by check, ACH or wire. And Landis wryly notes that KGC and most lenders aren't interested in lending against cannabis.

There are other concerns about the industry. The SEC has warned investors about the fraud associated with a hot sector like cannabis. And Michael F. Schaff, shareholder at Wilentz, Goldman & Spitzer, notes that there are many other complicating forces at work when evaluating the sector. He notes, "Internal Revenue Code Section 280(E) presents an immense challenge to the cash flow of cannabis operations in the U.S due to cannabis' status as a federally-controlled substance. Unlike a typical business, which is permitted to deduct the business expenses associated with carrying on its business, cannabis businesses can only deduct its cost of goods sold and not its other business-related expenses." And, cannabis-related businesses, even in states where cannabis is legal, are unable to file for federal bankruptcy protection. The federal and state legal and regulatory environment is fraught with challenges and many often conflict with one another, making it quite complicated for cannabis businesses to operate.

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The Bloom Off the Proverbial Rose

Another big stumbling block is ahead for one major segment of the industry—CBD companies. The FDA is looking into cannabidiol or CBD products to ensure the safety of consumers, as well as evaluate their therapeutic nature. Specifically, the FDA is warning CBD companies to stop making health claims. In July, the FDA put a hold on CBD food and beverage additives, choosing to conduct further investigation into ingestible products. Curaleaf Holdings, one of the largest CBD makers, served as the test case, citing the company for "illegally selling unapproved products containing cannabidiol (CBD) online with unsubstantiated claims that the products treat cancer, Alzheimer's disease, opioid withdrawal, pain and pet anxiety, among other conditions or diseases." Topical CBD items aren't yet on the FDA's radar.

Federal regulation isn't the only problem for the industry. Onerous state laws and regulations can make illegal marijuana more attractive and often cheaper. California, for one, didn't experience the expected outcome for sales of recreational marijuana. In a press release, Tom Adams, managing director and principal analyst for BDS Analytics' Industry Intelligence group, noted, "California's rocky start on full legalization was unprecedented." It became the first state to have legal spending on cannabis drop. BDS Analytics notes that the Golden State went from $3 billion in sales in 2017, when only medicinal marijuana was legal, to $2.5 billion in 2018—the year in which recreational marijuana became legal.

The Next Set of Hurdles

With any nascent and hot industry, investor and stock market enthusiasm can sometimes be a bit irrational. Borchardt worries that the cannabis industry might be experiencing a bubble similar to the dot.com era. "Many of these companies are borrowing tons of money, and expenses are

higher than expected," she notes. The summer saw a drop in stock prices of a number of major cannabis companies. "When there's a new frontier, it's hard to trust all of the numbers," she notes. And with the wholesale price of cannabis dropping and sales likely to plateau at some point, the future is a bit uncertain.

But what does that mean for secured lenders down the road? Borchardt notes that industry consolidation is rampant, at least for the stable, established and more-profitable companies. That could mean fewer quality businesses to work with when

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other funders get into the industry, she believes. "The companies that will need the financing at that point will be late to the party." The better companies are finding less difficulty getting investors, and these cannabis businesses are busily establishing financial relationships.

The future of cannabis financing certainly remains a what-if situation. At the moment, businesses in any way involved with marijuana production even find it difficult to put money into a bank, since it "raises the specter of reputational risk and prosecution for money laundering for the banks," says Smith. When bank accounts are opened at established banks, they are quickly closed when the nature of the business is discovered. Many in the marijuana trade are forced to purchase massive safes for their retail locations or pay private security transportation and storage firms to hold their cash at a secure place until they need it, which creates further financial burdens. "None of these options are acceptable or sustainable long term," he notes. Dispensaries are often awash in money and the proverbial cash stuffed in the mattress might be more realistic than many might imagine.

If and when banks will be able to accept deposits and finance marijuana-based businesses depends on the political tide. The momentum seems to be in favor of an eventual legalization on the federal level. The question is when? It doesn't appear to be in the very near future. But Smith believes there is some momentum for cannabis policy reform in Congress. He adds, "There are a lot of politics in play, and lawmakers are, unfortunately, still lagging behind the public on this issue."

That may be slowly starting to change. The Secure and Fair Enforcement (SAFE) Banking Act passed the House Financial Services Committee in March. The SAFE Banking Act of 2019, which would allow "depository institutions" to provide services and lending to the state-approved cannabis industry, could eventually be approved by Congress, says Smith. The American Bankers Association has come out to publicly support it. The Act might provide enough assurance for all but the biggest banks to feel comfortable working with the industry. "There may be some larger operators who continue to deny services to the industry until cannabis is legal, but once it is, I can't imagine any lenders still purposefully avoiding involvement in the market for a federally legal commercial commodity," he adds. Of course, a growing interest by established banks and well-known secured lenders isn't simply dependent on laws and regulations. Public perception is another point of concern for these institutions. **TSL**

Myra Thomas is an award-winning editor and journalist with 19 years' experience covering the banking and finance sector.