CARLTON FIELDS

Ledgers and Law: Roadblocks Facing the Cannabis Industry

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The cannabis industry faces numerous challenges given the current federal legislation and regulatory framework, including a lack of service providers, illusory insurance coverage options, and higher risk with fewer protections. Fundraising for cannabis companies can be particularly difficult. Chase Wright, a member of the professional practices group at Cherry Bekaert, discusses several avenues that companies in the cannabis space can take to raise capital for funding and expansion.

About Ledgers and Law: Lessons From the Trenches

Ledgers and Law: Lessons from the Trenches brings experienced business and legal leaders together to discuss current topics at the intersection of tax, law, and business. Ledgers and Law is co-hosted by Kevin McCoy, shareholder at Carlton Fields, and Chris Rux, Assurance Partner and Healthcare & Life Sciences Industry Practice Leader at Cherry Bekaert.

Transcript:

Kevin McCoy: Welcome everybody, this is Episode 3 of Ledgers and Law, a podcast collaboration between Carlton Fields and Cherry Bekaert. This is Kevin McCoy. I am a shareholder in the Tampa office of Carlton Fields. I do trial work, business litigation and products liability defense. I am here with my co-host, Chris Rux. He is a partner at Cherry Bekaert here in Tampa. We have with us a partner, Chase Wright, out of the Nashville office of Cherry Bekaert. Today we are going to be talking about issues that affect the cannabis industry. So without further ado I will turn it over to Chris for some intros and then we will get right to it.

Chris Rux: Thanks, Kevin. As Kevin mentioned, I am Chris Rux and I am an audit partner in our Tampa practice at Cherry Bekaert. I am also the health care and life science industry leader for the firm. It's great to be back along with you, Kevin, and looking forward with this conversation with Chase. Chase is one of our advisory partners based in Nashville who has done a lot of work in the cannabis space from a consultative standpoint. So hopefully we will have a great conversation here and dive into some interesting issues. So with that, Chase, let me just start off and throw a question out there to you. In your dealings with various cannabis companies, what are your observations about the lack of service providers or vendors, or general challenges of that nature?

Chase Wright: First off, Kevin and Chris it is a pleasure to be here with you guys today. Chris, I mean that is real. There are so many providers who are using the federal legislation against cannabis to avoid doing business with the cannabis companies. I mean it starts with the banks, right, especially those that are federally insured. You know they could face money laundering type charges in general should they do business with a cannabis company, or a cannabis company that distributes product. There are some alternatives but not good alternatives. And it goes beyond the banks. Think about your leasing relationships. Think about your payment processors for some vendors. For some companies this is a cash-only business because of lack of interaction with a payment processor. There are some options that are new but it's very pervasive. In general these companies don't have the same protection under bankruptcy laws in the U.S. that other companies do and so many, because of that, there are many service providers who just shy away, it's a real problem.

Kevin McCoy: You know I will tell you one observation I have seen gentlemen is not only on the banking and related service providers but insurance. Insurance is a huge problem and I will tell you I have personally looked at lines of coverage that have been offered to those in the cannabis space and they are illusory. There is no coverage whatsoever when you read the exclusions, the riders and they are still charging a premium. There is a very niche market of insurance providers who are really giving meaningful coverage to those. I am not even talking about on the high THC marijuana side, on the CBD side, low THC. You just have a lot of problems and it is something that they have to study closely. I mean they really need to be looking with a fine tooth comb at any kind of insurance coverage that they may be purchasing for their business even if it seems as benign as you know general liability or employee coverage, EEOC kind of stuff because there are so many exclusions that become a problem just because of the nature of the space. But that kind of turns to another question for you, Chase - you know typically even outside of the vendor context you talked about this being a cash business but they need to do fundraising or they need to do equity events and traditionally there are two paths: there is private money and there is public money. And what are you seeing in terms of the private money and the deals that are being done and the cost of that money relative to others who are outside of the cannabis space?

Chase Wright: Sure, well, in general, we had seen a lot more interest as more states come on line right from private equity. You know I think there is a tone of interest and there are some folks who are writing checks and so that's good but with those there is a supply and demand in private equity. There is a lot of dry powder out there but, you know there are still risks that a private equity fund has to contemplate. The same risks that we were talking about, Kevin. The risks around, you know, can these guys find a vendor to do business with, can they insure their employees? How will they attract talent because of these types of problems? So in general, I would say that private equity comes with a real premium. Over and above even other industries that are high growth, be it a device industry or early pharma industry. There is just a lot more premium that is required because of the risk that is out there.

Chris Rux: Yeah, Chase, I think you are spot on there. I just ran into that recently with a client of ours out in Oklahoma looking to raise some private funds and the premium charged was almost usury rates is what they were getting. So they were really struggling to get the capital they need to run a proper business, have the proper systems and controls and policies and procedures and personnel in order to run it just like any other company. So it is a problem but you know, Chase, you kind of brought up the public market. What are the avenues that you are seeing companies take from a public standpoint acknowledging that currently you can't technically go public in the U.S. given the federal laws?

Chase Wright: Yeah sure, you guys follow the industry close enough. You probably have heard the Canadian stock exchange, the CSE, the CSE acronym is also known as the Cannabis Stock Exchange. Because there are a lot of companies who have found liquidity by listing in Canada. But that is not a perfect solution by any means. In fact, lately we have seen it become less popular. You know in general, first off in the U.S. essentially cannabis is regulated at the state level, federally illegal, but regulated at the state level for practical purposes. In Canada, federally legal and you can list and trade on the exchange. In the U.S. you can be public you just can't be listed, you can't trade on any of the exchanges none of the exchanges allow the trading. In general, the risks that brings if you are a foreign investor and you invest in a Canadian company, doing business in the U.S. there are certain custom and border protection laws you can face should you try to enter the U.S. you know detention, denial of entry, etc. And then the other real downside is the requirement to list, in Canada you can go public with U.S. Gap financials but eventually you have to transition over to a different set of accounting standards mostly IFRS. The reporting under IFRS is very different than U.S. Gap for this industry. In particular, it creates one of the most contrast of any industry I have seen. So a lot of U.S. investors do not understand the financials and it creates a lot of stress for the CFO trying to explain the IFRS financials to U.S. investors. So, that is an option but it comes with a lot of caveats.

Kevin McCoy: It sounds like in some ways, the first place my mind goes Chase, it's like a bad law school exam in terms of all the international layers of civil procedure and complexities and everything else. But it sounds like what you are saying is there is more expense. You are going to jump through more hoops. You know there is no cheap pack here given the current regulatory framework no matter where you go. Whether it is on the private side, whether it is on the public side. But talk to our audience a little bit more about why going public and going public on the Canadian exchange could be an option for people if they so choose.

Chase Wright: Sure and good point Kevin, in some of the companies that are public in Canada dual list on the Canadian exchange where they trade but are also public in the U.S. So to your point around costs, you have doubled the regulation costs as far as listing, if that is the case. But, you may also have two different sets of financial statements, one under IFRS and one under U.S. Gap. There are a lot of companies who have created very significant market cap cannabis companies by trading in Canada. It is still a very hot industry. You know you see various funds EFTs set up on the U.S. investing in cannabis. So you know liquidity is there for sure, it is not the perfect solution because of all of these challenges within the industry. But, in general there is a lot of investor interest lower than the private equity level, the individual level where there are traders who want some action and you can get action and raise liquidity through the Canadian exchange.

Chris Rux: Yeah I think it is a good point and I think another thing to bring up something that I have observed is it is not just U.S. companies that are going to the Canadian exchange for liquidity. I was speaking with a colleague in Colombia the other day and he mentioned that there are companies down there that are also looking to go public on the Canadian exchange because it is like Chase said, the Cannabis Stock Exchange. The world is effectively trading there so it is a very interesting scenario for companies. But in that regard, Chase, you mentioned the dual filing - in your experience, what challenges have you seen with companies as they perhaps previously worked or continued to trade on the Canadian Exchange but then also may have to file in the U.S. as well?

Chase Wright: That is a great question. I would say the CFO's job becomes inherently more difficult should that be the case. The differences between the two sets of accounting standards are very significant under IFRS. Essentially your inventory is subject to fair value so you end up accelerating quite a bit of net income through a fair value adjustment to your inventory. It is a noncash type adjustment and so very similar to how you might fair value equity or debt you essentially fair value your inventory and so your profits are accelerated. Generally if you look at one set of financials, one under IFRS and one under U.S. Gap, you know for a cannabis company you would typically see under U.S. Gap 50 to 75 percent reduction in net income. So if you are a CFO trying to explain that to an investor that is interested in the industry you know, maybe even knows the industry a bit it is a hard pill to swallow and it is hard to explain and hard to understand. So, you know we see some more sophisticated companies wanting to move away from IFRS if they gain scale and they found enough financing so that they can present under one set of standards to eliminate that type of confusion.

Kevin McCoy: What is the take away here, Chase, for companies who are considering the fundraise or liquidity event. We just did an episode with one of your colleagues - episode 2 - where we talked about thinking about your end game on the front end. What is your exit strategy? It sounds to me like that is still a key here. You know you need to be thinking about that on the front end. Is your goal to sell private or is your goal to go public but talk about how companies now can plan for that and put in place some of those steps so that they are ready to move if they hit that growth spurt and they are ready to do it or they need to fundraise for operations or whatever reason they might want to get into this analysis but they got the building blocks already in place?

Chase Wright: It's a great question, Kevin and Chris. You probably can contribute to this question as well. Generally, you know I think all options are on the table for cannabis companies and the solution that fits one is not the right solution for all. I think private equity is a very viable route and I think that there is a lot more interest but with that again comes an expensive investment. You know a lot of cannabis companies, or the larger cannabis companies, are now moving toward the U.S. exchange and they are watching the political environment and they are watching this election season. The trading on the NASDAQ on all of our exchanges is not illegal - there just is no safe harbor that has been given to the exchanges that actually do the trading. So politics is important. The Canadian exchange still is a viable route if you can overcome those hurdles that we talked about. So I would say that it depends upon the size and the facts and circumstances. But that the more mature companies we see looking to list on the U.S. exchange to start explaining their financial results. I think it provides creditability to private equity. I think it provides creditability to everyday vendor to be public and to have SEC financial statements. Of course you can't trade now but that spigot could be turned on with some political maneuvering. So I think a lot of folks want to be there.

Kevin McCoy: Yeah, that's an interesting point, not to get political on this podcast, but irrespective of who wins the election that is coming up here very shortly, if for some reason the tides were to change in the United States you are suggesting that some folks may be chilling on going public right now but getting their ducks in order to go public in the United States if that market opens up is what I think I hear you say.

Chase Wright: Yes, the more you read, the more you talk to these companies, I think there is a real interest in having your financials filed with the SEC and having SEC financial statements ready perhaps having done an SI to have public ability to trade should the political tides turn. We definitely see that and in the interim I think having the creditability of having your financials approved by the SEC provides a lot whether it is to the private equity markets or again to your state charter banks to vendors in general who provide services to cannabis companies.

Chris Rux: Chase, I think you kind of hit the nail on the head with one word there: it is creditability. To get back to Kevin's original question, I think that is what companies in this space need to focus on is insuring that they have the proverbial house in order. Whether that is from a financial standpoint in terms of policies and procedures or systems or whatnot, but the ability to demonstrate creditability is going to lead to their ability to either raise capital to expand fund operations or otherwise or when they want to exit. So whether that is private equity, venture capital going public trading in Canada or the U.S. at some point in the future it is really about that creditability of the operations and of the personnel and the people that are involved. That has to be a focus from the get go because as we talked about last podcast, every time a business starts you should be thinking about the exit and that's a key component especially in this industry.

Kevin McCoy: Yeah. Well this has been great guys, that's our time for today. Chase, thank you so much. This was insightful, this is great, I love the ongoing conversation kind of in real time as we are watching things emerge here even politically and in this space. Chris, thank you as always - as everyone who's been listening knows you can catch this content on the website for Cherry Bekaert and Carlton Fields. This has been episode 3 of Ledgers and Law. We hope to see you for future episodes. If you enjoy it reach out and let us know if there are topics that you would like to hear about. Thank you very much. Everybody have a great day.

Chase Wright: Thanks gentlemen.