

Cannabis Financing Market Insights

Davis+Gilbert recently attended the Benzinga Cannabis Capital Conference, where the most significant and influential industry participants met to discuss the opportunities and challenges of funding growth in the cannabis industry. Joseph Cioffi moderated a discussion regarding the experience of Real Estate Investment Trusts (REITs) and the outlook for financing and regulations.

This piece contains some key takeaways to help participants operate effectively in the space and plan for the future.

Expectations for Legal Reform

Most agree there will be no new significant law enacted by Congress until after the mid-term elections. Hopes have faded for the Safe and Fair Enforcement (SAFE) Banking Act to become federal law within the next twelve months, and the Cannabis Administration and Opportunity Act (CAOA) probably won't be introduced in August as announced.

The market has learned to adjust to less-than-ideal conditions while maintaining hope for progress in Washington.

Lending and Capital Alternatives

As the industry grows, so does the pool of capital-provider and product options. Cash flow lending has risen to meet demand as many operators face a cash crunch due to high product costs and Section 280E of the Internal Revenue Code, which generally precludes cannabis-related businesses from taking deductions for operating expenses.

Equity REITs, which provide capital through sale lease-backs, remain a vital source of liquidity for operators with valuable real property. Investors are benefiting from the long-term structures, while

Joseph Cioffi, Partner and Chair of the Insolvency + Finance Practice Group at Davis+Gilbert, led a discussion regarding REITs and financing in the cannabis space at Benzinga's Cannabis Capital Conference on April 21, 2022.

Davis+Gilbert practices across many established and emerging markets and is a leader in navigating the evolving legal requirements of the cannabis business.

[Watch the full interview >](#)



operators are enjoying lower costs and may be permitted more flexibility in operations than they would with traditional lending.

Mortgage REITs are also providing capital to operators with valuable real property available as collateral. In any case, although real property is a key consideration, it is only one element in a robust underwriting process that includes evaluating strength of management and financials, the ability to raise capital and the applicable jurisdiction.

Even REITs, which are enjoying success in the current regulatory environment, would welcome the SAFE Banking Act. Although it would increase competition, it would also drive more and cheaper funds to the space for both operators and funders, resulting in a net positive. Further, after SAFE becomes law, financing in the space would slowly evolve and shape to the market needs rather than change overnight, all depending on the then-current state of regulations, including market participants, license and collateral values, and industry outlook.

Social Equity

Participants have been disappointed with the results of social equity programs to date and are concerned about proposed plans, based on their lack of dollars allocated per licensee and lack of educational support to help social equity licensees become successful. Creative professionals are trying to work with state and local governments to establish more holistic plans to support these licensees. The shortcomings of social equity programs create risks for investors touting ESG principles, where good internal governance (or climate-friendly conduct) is lacking.

Protecting the Downside

Profitability remains a challenge for operators in the current environment. Given cash needs, inflation, rising interest rates and evolving laws, capital providers must be vigilant in their diligence, underwriting, valuation and documentation.

There is growing sentiment that operators and funders should pair up now. And yet, as overall growth occurs, the amount of consolidations and liquidations will naturally widen. In transactions at this stage, protective structures and provisions, such as alternative ownership or use of real property, must be put in place before any signs of trouble appear.

A New Information Era

As the industry grows, so does the need for reliable information at all points in the cultivation to consumer process. Forward-thinking entrepreneurs are working to augment product sales data, including with consumer feedback on physiological effects, while investment and deal data is compiled and tracked, helping to set market expectations and more reliable benchmarks for valuations. Access to information will help make operators more valuable to capital providers and in turn attract more funding to those providers.

More Value, More Collateral, More Funding

Ahead of changes in federal law, investment by Canadian-based and U.S. operators in brand development and proprietary processes and services will rise significantly, creating greater asset and enterprise value among operators, thus supporting larger and less costly funding.

Litigation

A class action lawsuit recently filed against REIT Innovative Industrial Properties (IIPR) could influence deal structures, perceptions of risk and costs in the market, if it gains any traction. In the suit, an IIPR shareholder is suing the REIT for violations of federal securities laws based on alleged improper valuation of properties and cash flows and mischaracterizing its business purpose. The suit's viability is uncertain given the speculative nature of the claims and extensive references to a short-seller's report that precipitated the share price declines. However, it needs to be watched carefully. If it survives a motion to dismiss, plaintiffs will be emboldened to pursue similar claims against REITs, attacking the sale-leaseback structure.

Looking Ahead

As an established market with nearly 50 million users (despite not even being legal in all 50 states or at the federal level), cannabis is fertile ground for capital providers catering to the market. As the market evolves and matures, it will attract more dollars and providers. Greater competition and availability of funds should lower financing costs at all levels, while the development of valuable brands and intellectual property provides additional value to support larger credit extensions and equity investments, all of which will further spur industry growth. Success attracts unwanted attention as well, however, as evidenced by the action against IIPR. Capital providers must be aware of the legal risks.

Whether you are a capital provider or operator seeking to form successful financing arrangements, guard against financial distress of counterparties, protect rights in intellectual property, or assert or defend legal claims, Davis+Gilbert is here to help.

For More Information

Please contact Joseph Cioffi or the Davis+Gilbert attorney with whom you have regular contact.



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Possessing, using, distributing, and/or selling marijuana or marijuana-based products is illegal under federal law, regardless of any state law that may legalize or decriminalize such activity under certain circumstances. Although federal enforcement policy may at times defer to states' laws and not enforce conflicting federal laws, interested businesses and individuals should be aware that compliance with state law in no way assures compliance with federal law, and there is a risk that conflicting federal laws may be enforced in the future. No legal advice we give is intended to provide any guidance or assistance in violating federal law.

Davis+Gilbert is a 120-year-old law firm in New York City that has a history of entering emerging markets early and helping them to grow. We offer valuable services for both the operators and capital providers of cannabis businesses.

- We help navigate lending laws and regulations, commercial real estate financing and leasing and other areas that make cannabis especially complex, such as applicable state-based creditor rights and enforcement proceedings.
- Beyond providing financing guidance, we are a leading firm in advertising, marketing, trademark and intellectual property issues. We use that knowledge and industry know-how to help cannabis companies establish themselves in the U.S. market.