New York Legislation Favors Existing Operators

March 31, 2021

New York lawmakers voted to legalize recreational cannabis last night. With a signature from Governor Cuomo, New York will be the sixteenth state in the US to legalize cannabis and the second state this year to pass initiatives through legislation (following Virginia in February). We expect the rollout to take some time and anticipate initial recreational sales in 2022.

Importantly, the New York legislation reflects the continued shift in attitudes for cannabis in the US and presents attractive opportunities for cannabis operators in the market and investors. New York will quickly become the biggest cannabis market on the East Coast. We estimate sales to reach $1.9B by 2025.

Sustainable advantages for existing operators in new law

There are ten licensed operators in New York: Acreage, Columbia Care, Cresco, Curaleaf, iAnthus, Etain Health (private), Green Thumb, MedMen (majority of assets have been sold to Ascend Wellness), Pharmacann (private) and Vireo Health.

As previously mentioned, we anticipated these companies would benefit from their established position with the transition to recreational sales through the receipt of initial licenses and by having an established infrastructure to leverage as other operators build scale. The early mover advantages have come in each expansion market to date and will continue in future expansion states.

What appears unique about New York regulations though is that, as the law stands today, existing operators will be grandfathered long-term advantages, creating an unequal playing field for new entrants. Today, existing license holders are permitted to have four medical dispensaries and are required to be vertically integrated. Under the new law, the license holders can open four more dispensaries with three of eight to be permitted for recreational sales. All new entrants to the market will be capped at three total stores. Medical only dispensaries in rec markets can still be solid revenue generators and these additional stores could be sold-off. Additionally, the existing license holders can remain vertically integrated and are permitted to expand cultivation and production capacity. Vertical integration for new operators is prohibited, with MSOs entering the market required to be either exclusively retailers or 3rd party wholesalers. Vertical integration enables a significant margin advantage for existing license holders.

Using rough Massachusetts pricing ($4500/lbs. flower retail and $3000 wholesale) and cost of production ($1200/lbs. flower) as a proxy for New York, the existing New York license holders can achieve a 73% gross margin on the sale of one pound of flower while a non-vertically integrated retailer achieves 33%. Meanwhile, a strictly wholesale operator gets 60%. This margin comes before factoring in the state's planned excise tax based on THC content level. The excise tax is the burden of the distributor and incurred by the wholesale producer but likely partially passed on as part of the wholesale price. It appears that this cost will not be incurred for in house sales for vertically integrated operators widening the margin gap.

For the existing operators, we expect competitive advantages combined with the scale of market sales to translate to disproportionate top line growth and profitability. For the operators willing to sell assets, we expect existing licenses to be sought after and valued at premium multiples.

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Investment Highlights

- New York becomes 16th state to pass cannabis legislation. State will quickly become biggest cannabis market on East Coast.
- Significant long term advantages exist for legacy operators including vertical integration and more dispensaries.
- Assets for existing operators will be top producers and/or attractive acquisition targets.
- New licenses can still be attractive for new entrants.
- Pull back in cannabis industry at a time when news continues to be positive presents an attractive investment opportunity.

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New licenses will be sought after but as a secondary option

Even while the vertical integration prohibition on new entrants makes New York expansion through license receipt less attractive, we continue to anticipate significant interest amongst MSOs in obtaining licenses. In particular, we expect MSOs to focus either on retail operations near New York City or other populous parts of the state or to operate as wholesalers to the market. Wholesaling as reflected by the previously referenced margin equation can be a highly profitable business (and cash generator) in new rec markets. In Massachusetts, operators including AYR Wellness and TILT have proven the highly profitable opportunities from wholesale operations in an under supplied developing markets.

Market pull back presents beneficial opportunity given improved conditions and execution

The New York news represents a major milestone for the cannabis industry, opening another populous state on the East Coast.

YTD, cannabis expansion has outperformed expectations with the passage of legislation in two sizable east coast markets in New York and Virginia and the opening of sales in Arizona. Meanwhile additional legislation is looming with New Mexico likely the next state to pass cannabis legislation through a special legislative session in the coming weeks. We expect additional states including Connecticut and Pennsylvania to also pass legislation in the near term.

In terms of medical cannabis expansion, in Tennessee and Alabama where medical cannabis has to date been prohibited legislation to open initial medical sales is progressing at the state level and in two of the country's most restricted markets (Minnesota and Texas) legislators continue to discuss sizable expansion initiatives. We remain confident in our forecast that by 2025 all US states will permit medical cannabis sales at scale. Additionally, at the federal level, initiatives related to enhanced banking access continue to progress.

In terms of operations as noted in the recent Viridian Capital "Chart of the Week" many operators outperformed expectations with Q4/20 earnings results and we anticipate a stronger than expected Q1/21 due to improved macro conditions and the receipt of stimulus checks. Beyond the first quarter, we expect an uptick in demand to come from a loosening of COVID-19 restrictions as the vaccination rollout across the country progresses. Meanwhile, many companies which announced significant acquisitions in late 2020 and early 2021 are making progress in integrating these assets. These expansion initiatives are prime to provide top line growth and margin expansion for the consolidated companies. Within our coverage that includes AYR which has closed acquisitions to enter Arizona, Florida, Ohio and Pennsylvania, Driven by STEM which acquired Driven Deliveries and Lowell Farms, formerly Indus Holdings, which acquired the Lowell Herb Co. brand.

Overall, news remains positive in US cannabis. Never-the-less, since early February cannabis stocks are down significantly (-23% as reflected by the Alternative Harvest ETF). This compares with a 4% decline for the Russell 2000 and a 1% gain for the S&P 500. While cannabis stocks are still very much outperforming YTD (+55%, versus 13% and 7% respectively), we feel that the recent underperformance presents an attractive buying opportunity for investors particularly investors considering companies for which the macro improvements are significantly more attractive today than they were at the start of the year.

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