BianchiBrandt

A Corporate Law Perspective on *The Great Correction* in Cannabis M&A

A BIANCHI & BRANDT TREND REPORT

When the U.S. Department of Health and Human Services responded to President Joe Biden's request and provided a historic scheduling recommendation for cannabis to the DEA in September 2023, cannabis markets of all kinds responded in grand fashion, making the need for an updated deep dive into cannabis M&A all the more necessary.

This report assesses the current M&A environment at a historic time that we refer to as "The Great Correction," and what it means for U.S. cannabis operators—and the global investors fueling the industry in absence of federal legality and access to traditional banking services.

Since founding Bianchi & Brandt, we've represented cannabis companies in more than $500 million of inbound and outbound cannabis M&A transactions in medical and adult-use markets across the U.S. We often find ourselves matchmaking among long-term clients, colleagues and trusted partners as they navigate the complexities of the ever-evolving industry, developing strategic, mutually beneficial partnerships.

We entered the nascent field of cannabis law several years before founding the firm, supporting entrepreneurs and regulators alike in the early years of the green rush—an era of confidence and cash flow without the wisdom of data to drive decision making. Not surprisingly, our growing industry is now experiencing real growing pains.

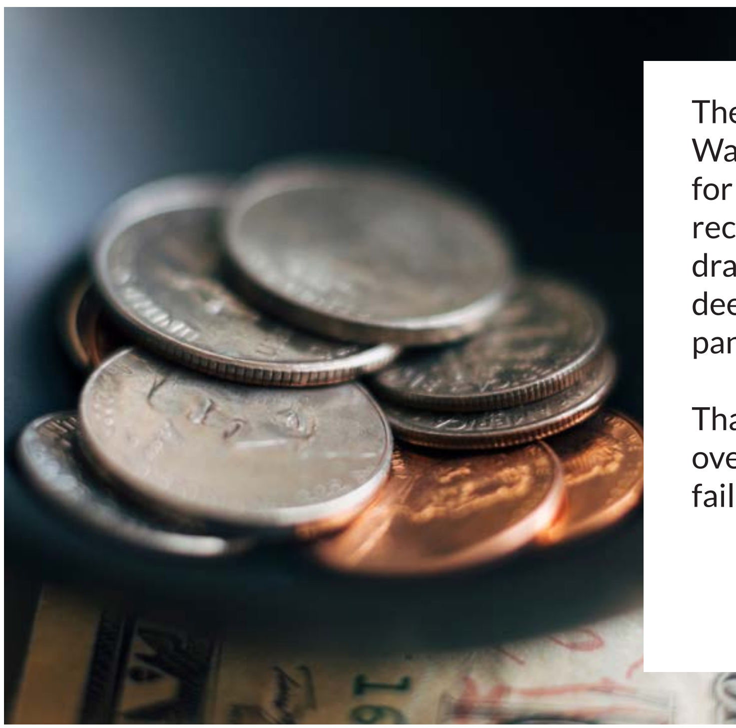
The pendulum of opinion about the future of cannabis swings wildly. As founding partners with decades of combined experience spanning every aspect of the industry, we understand the critical issues—from the most finite details of employment, compliance and IP, to wide-reaching transactions in real estate, M&A and multistate operations. Our firm's modus operandi is not to get swept up in the tide of emotion, but to take a 360-degree view, combining careful analysis of the current trends with our deep experience to drive business growth.

We developed this trend report for our partners in hopes of kickstarting this existential conversation, which will dictate the future of legal cannabis globally. We look forward to continuing the conversation with you.

Laura A. Bianchi **Justin M. Brandt**

CHAPTER 1

The Green Rush Is Over



The economic boom began in 2012 when Washington and Colorado legalized cannabis for adult use, jumped in 2018 when California recreational sales started, and surged dramatically again when legal cannabis was deemed “essential” by many states during the pandemic’s early lock-down phase in 2020.

That script has since flipped to a scenario of oversupply, widespread layoffs, investment failures and plummeting stock prices.

The type and scale of cannabis M&As that the industry enjoyed prior to and during the pandemic was “corrected” in 2022 after the recent industry crash, and market conditions have returned M&A activity to a more grounded environment. Small and midsize businesses (SMBs) are now the focus of most of the activity.

Frank Colombo, Director of Data Analytics at New York-based Viridian Capital Advisors, wrote in January: “2023 will be a banner year in rescue financing, distressed M&A, and restructuring both in Canada and the U.S.”

CHAPTER 1 CONTINUED

Some important contractions have rebalanced the market in a manner that few anticipated. According to New Frontier Data in its *Cannabis Capital: 2023 Industry Market Report*, while the average size of equity raises decreased 44% between 2021 and 2022—from $22.2 million to $12.4 million—so did the debt. In fact, debt raises decreased by over half YOY, dropping from $45.7 million to just $21.5 million.

With a noticeable capital contraction cooling the frenzy, companies are still engaging in M&A activity, creating what Canadian Securities Exchange CEO Richard Carleton called early in 2023 a "perfect storm" of SMBs being subject to M&A activities. Carleton also noted that capital fundraising among American multistate operators (MSOs) was down roughly $4 billion in 2022 compared to 2021.

But it is not all doom and gloom. And this is not abnormal. Market corrections are a necessary pathway to the long-term health and sustainability of the cannabis industry—and we've been working with our clients and partners to anticipate *The Great Correction* at hand so we can be prepared for where the market is headed next.

"We've been entrenched in the hyperactive cannabis M&A environment for many years, and after the massive, unexpected pandemic bump—and the ensuing crash of cannabis markets coast to coast—we're now in The Great Correction. "

—Laura A. Bianchi

CHAPTER 2

Looking Beyond Standard M&A Factors

Of course traditional M&A is driven by market share, core competency and elevated efficiencies. But today's cannabis M&A climate prioritizes these values—in addition to some non-traditional factors, including:

- Complex licensing structures
- Real estate zoning restrictions
- Vertically integrated operations (cultivation + manufacturing + retail)
- Wildly different state regulations and lawmaking infrastructures

Navigating the post-pandemic cannabis market is not easy, considering the scale of lower-than-expected financial performances and lack of available capital. It is no longer the size and breadth of a company's footprint that investors judge; they're scrutinizing margins, earnings and cash flow, along with how efficiently the company handles the sector's unique regulatory, operational and management obligations.

Investors must agree on the long-term goals of the organization and prioritize initiatives to make the business solvent for the long run. Lowering overhead while increasing revenue, protecting any IP and achieving economies of scale should be at the top of everyone's list. In the current environment, we're also seeing much lower valuations with adjustments to market realities.

CHAPTER 3

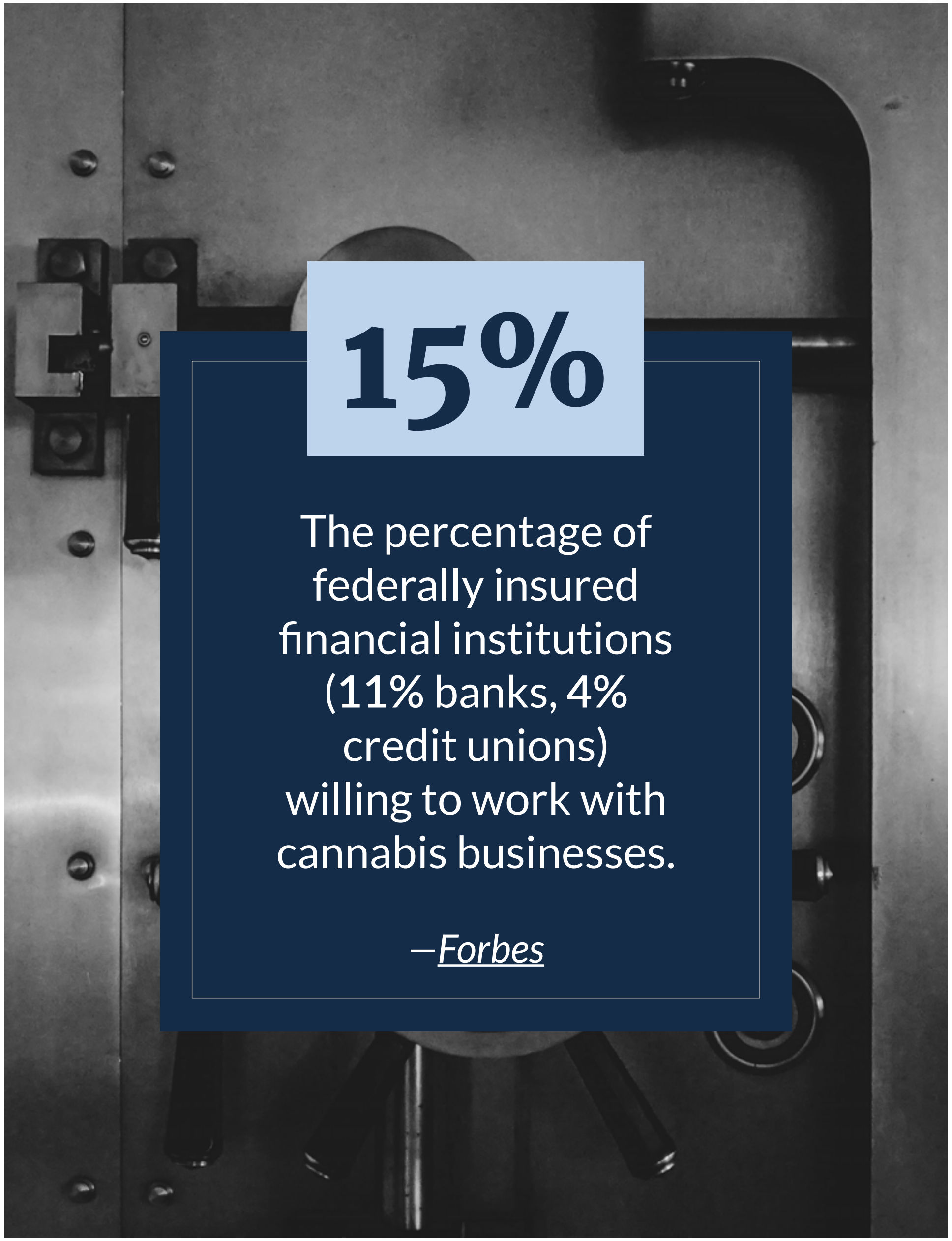
The Role of Recessionary Thinking is Real

Despite the old axiom that vice products are "recession proof," the global inflationary woes and macroeconomic issues the U.S. is dealing with continue to leave their mark on cannabis.

The current recessionary thinking has investors getting cold feet, and those feet are even more frigid when they're talking about investing in the federally illegal cannabis industry. That illegality translates to limited access to all types of capital—including the most basic banking services, which businesses in other industries take for granted.

The failure of Silicon Valley Bank justifiably made headlines and enforced investors' wary outlook because of the services the bank provided to ancillary cannabis businesses. Their risk-averse or "risk-off" strategy is only increasing the difficulty of raising capital in cannabis.

CHAPTER 3 CONTINUED



15%

The percentage of federally insured financial institutions (11% banks, 4% credit unions) willing to work with cannabis businesses.

—*Forbes*

Even big cannabis companies are getting frozen out of financial support. California-based Herbl—which reportedly handled $700 million worth of product sales in 2022—made headlines for the wrong reasons when it went into receivership in June of 2023 after falling behind on a key loan. And now the brands and retailers that worked with Herbl are not getting paid as expected.

The late-July mutual termination of a $2 billion merger between MSOs Cresco and Columbia Care is the most prominent example to date of a more cautious mindset by executives and investors, adding to other recent MSO struggles such as those seen with MedMen, Curaleaf and Canopy Growth.

CHAPTER 4

Regional Policy Continues to Drive Cannabis M&A Velocity

In cannabis, no two state markets are the same, and the variation among regulations is staggering—especially in how they impact M&A velocity, valuations and more. Just to name a few:

- Caps on statewide licenses (including local restrictions) vs. open markets
- Licensing structures (including vertical or horizontal integration)
- Medical cannabis program requirements
- Allowable product categories, including edibles and concentrates

> "Investors who are new to cannabis are often surprised to learn that licenses in Arizona or Illinois are more valuable than licenses in Colorado or California—but then they learn about one of the most complex realities of this state-by-state patchwork of varying license structures, and they get it."
>
> *—Justin M. Brandt*

CHAPTER 4 CONTINUED

In Utah, licensed medical operators are enjoying great success primarily due to the newness and restricted size of the market. In Illinois, caps on licenses and their scarcity make them highly valued and highly coveted. In a head-to-head comparison, Arkansas' 38 medical dispensaries servicing its 3 million residents are worth significantly more in acquisition value than Oklahoma's 2,800 medical dispensaries servicing the state's 4 million residents. Investors are currently doubling down in Florida, betting on a potential adult-use vote in the coming year or two.

New York, which is positioned to be one of the largest cannabis markets globally, is an instructive case of access fueling M&A activity.

Capital raises and M&A transactions surged after New York legalized recreational sales. The recent announcement of 1,500 new cannabis business licenses and extended application deadlines will only increase the M&A enthusiasm pervading the Empire State.

A comprehensive 2022 study shows that "states tend to license medical cannabis more restrictively than adult-use cannabis: i.e., by offering licenses in fewer categories, at higher cost, in lower issuance volume, and more often mandating vertical integration." The same study found that states that implemented medical and / or recreational markets earlier than others tend to offer licenses in more categories, at lower cost and in greater volumes.

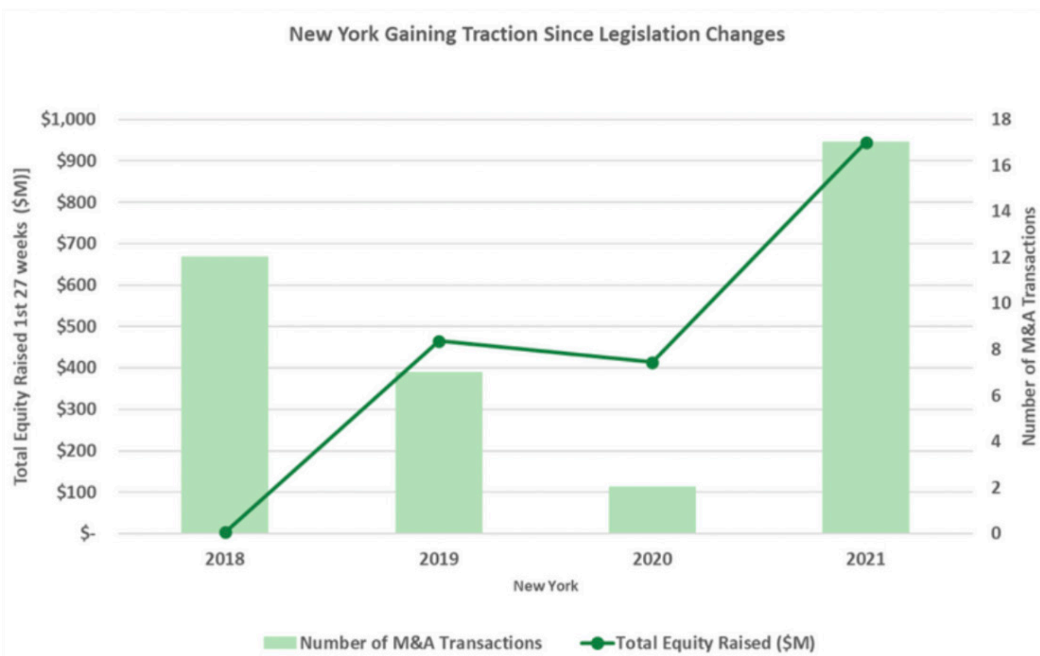


Figure 1. Viridian Capital Advisors

CHAPTER 5

SMBs are the Engine of the Cannabis M&A Economy

Whereas previous cannabis M&A movement saw large-scale deal flow driven by multistate operators, those sizable deals are no longer common. The current M&A market is squarely focused on smaller deal flow.

To add insult to injury, MasterCard earlier this year instructed U.S. financial institutions to stop allowing purchases of cannabis on its debit cards, further restricting banking service options for cannabis businesses.

Canadian Stock Exchange CEO Richard Carleton told *Green Market Report* in February 2023: "Total U.S. targeted cannabis M&A is down 73.6% over the trailing twelve months, and the first four weeks of 2023 saw an even bigger drop, off nearly 98% from January last year."

Small- and medium-size businesses power all U.S. business sectors—including cannabis, now that the *The Great Correction* is setting in.

Current mergers are taking place because the opportunities are evident to both parties and the strengths and weaknesses of their cannabis businesses complement one another.

> "Savvy businesses are looking for mutually beneficial partnerships that allow them to maintain a foothold in the market to ride out this correction. Many of these smaller cannabis businesses are merging for basic survival. Some are finding that their new partnerships are helping them thrive in these conditions. Others are entering into bad partnerships out of desperation, and we will likely see them in court in the future."
>
> *—Laura A. Bianchi*

CHAPTER 6

With So Many Distressed Assets on the Block, the Price is Right

> "Our clients are remaining disciplined when it comes to shopping for acquisition opportunities. While there are certainly M&A opportunities involving distressed assets, we're seeing more joint ventures—where you're bringing on an operational partner to take over the distressed asset—rather than outright acquisitions. Sellers want cash and most buyers don't have that readily available right now."
>
> *—Justin M. Brandt*

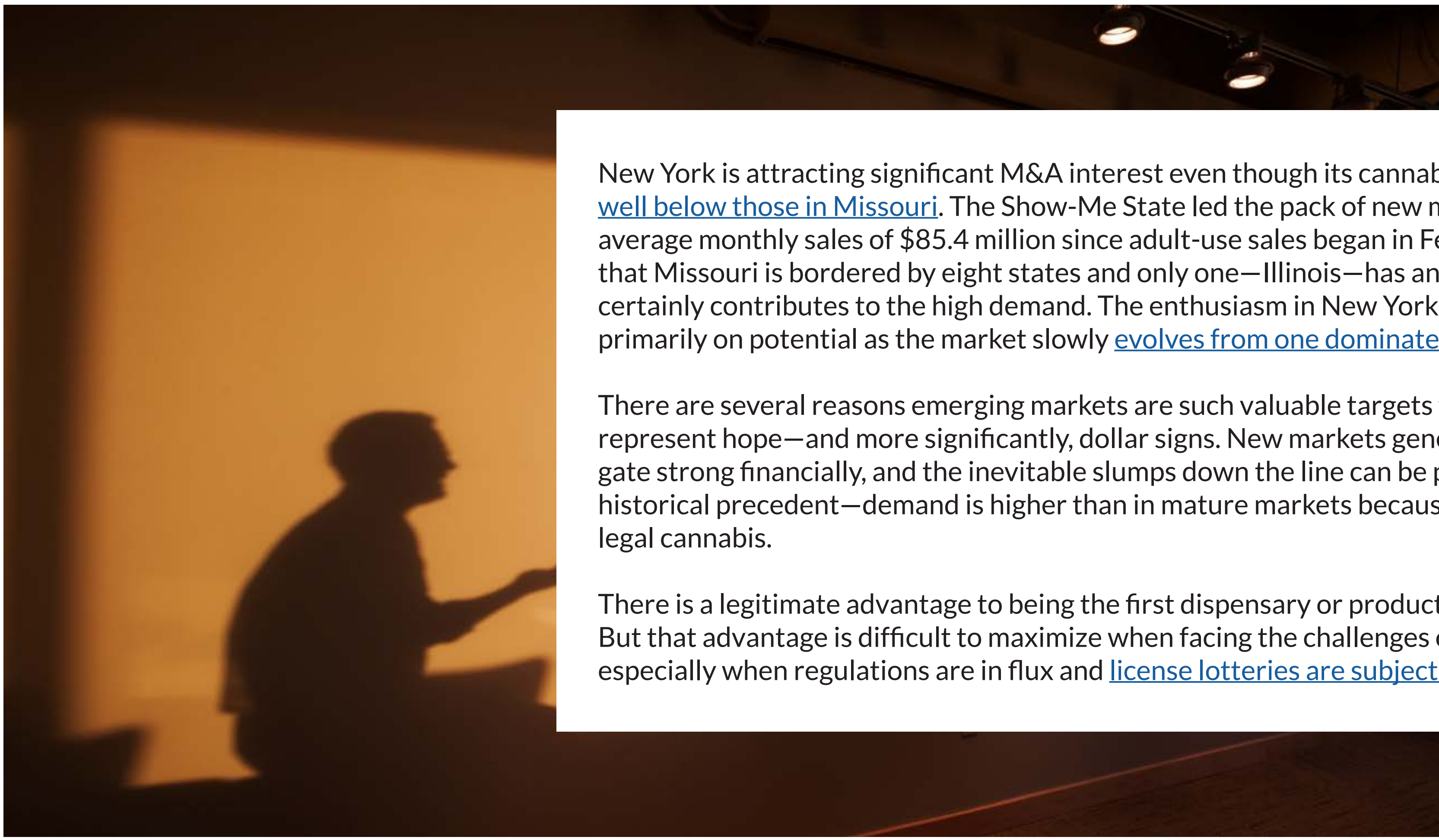
Mergers do not necessarily require capital—two entities can still merge if the balance is right. For many operators that have been waiting in the wings, taking on a distressed business at a deep discount presents opportunity. It is unique from traditional M&A opportunities, but it is an option for patient and responsible operators. They just need to run serious M&A due diligence prior to making a move.

A recent report published in *Cannabiz Media* noted, "Where cannabis M&A activity in 2019 and 2020 was mostly driven by industry optimism and an influx of new capital entering the cannabis space, activity in 2023 and into 2024 will be driven by distressed, cash-poor companies being acquired."

In the early days of cannabis, brand valuations were absurdly out of line with reality—and those days are far behind us. And although there is a great amount of distress in the industry, in the end, *The Great Correction* will eventually elevate industry valuations to stronger, more steady and viable long-term positions.

CHAPTER 7

Emerging Markets in M&A Spotlight



New York is attracting significant M&A interest even though its cannabis sales thus far fall well below those in Missouri. The Show-Me State led the pack of new market participants with average monthly sales of $85.4 million since adult-use sales began in February 2023. The fact that Missouri is bordered by eight states and only one—Illinois—has an adult-use program, certainly contributes to the high demand. The enthusiasm in New York appears to still be based primarily on potential as the market slowly evolves from one dominated by illicit sales.

There are several reasons emerging markets are such valuable targets for M&A. New markets represent hope—and more significantly, dollar signs. New markets generally come out of the gate strong financially, and the inevitable slumps down the line can be predictable based on historical precedent—demand is higher than in mature markets because of sudden access to legal cannabis.

There is a legitimate advantage to being the first dispensary or product brand in a new market. But that advantage is difficult to maximize when facing the challenges of being the first mover, especially when regulations are in flux and license lotteries are subject to lawsuits.

CHAPTER 8

Why Cultivation and Retail are Top M&A Targets

Data shows that some of the hottest M&A targets in the current cannabis business climate are cultivation and retail licenses. In the second half of 2022, cultivation and retail M&As dominated the North American market with 66.7% of all deals, according to a Viridian / EY report.

As mentioned in Chapter 6, low valuations of dispensaries and other assets across the industry mean it is a better time than ever to acquire retail licenses. Meanwhile, wholesale cannabis prices are the lowest they have ever been, and many operators are struggling and seeking some type of relief.

This emphasis on cultivation and retail licenses speaks to existing businesses' need to invest in core competencies and efficiencies in order to survive. When a business controls the supply chain in a highly regulated industry like cannabis, its operators can control their destiny—in margins, in compliance and in overall success.

Any company vertically integrated to control the bookending roles of growing and selling enjoys the seed-to-sale oversight of products that can mean the difference between solvency and liquidation.

> "It depends on the market. In states where there's an under-supply of product, cultivation licenses are typically more valuable. They are less valuable in more mature markets where operators are facing significant pricing pressure due to wholesale surpluses."
>
> *—Justin M. Brandt*

IN SUMMARY

The *Desperate* Need for Federal Action, a.k.a. a 'New Deal' for the U.S. Cannabis Industry

Almost a century ago, America had The New Deal. That series of government-driven programs and financial reforms spurred the U.S. economy and lifted it out of The Great Depression.

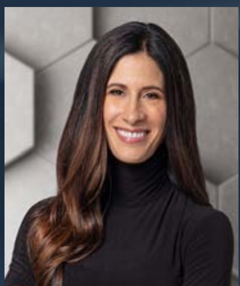
To fully emerge from the doldrums of the current post-pandemic crash, the modern cannabis industry requires similar government-driven programs (i.e. the SAFE Banking Act and the removal of cannabis from its prohibitive federal status as a controlled substance), as well as financial reforms (i.e. the desperate need for tax reform and addressing IRS tax code 280E restrictions). The recent news that the SAFE Banking Act was amended to include a new title—the Secure and Fair Enforcement Regulation (SAFER) Banking Act of 2023—and that the Senate Banking Committee voted to advance the Act to the Senate floor is most welcome.

In the last year something else significant occurred beyond Congressional legislation. When the White House in October 2022 tasked the head of the Department of Health and Human Services and the U.S. Attorney General to "review expeditiously" the status of cannabis as a Schedule I controlled substance, it cracked open a door that has stayed closed tight since Colorado and Washington first legalized adult use. If cannabis were rescheduled—as recommended by the Department of Health and Human Services to the DEA—it would eliminate the absurd 280e restrictions, create a much more valuable business climate, and a prompt a surge in M&A in the sector.

The Great Correction might already be underway, and there is now some hope that the necessary federal policy reforms for these state-legal industries to fully flourish—and for the M&A confidence index to return to more steady, market-relevant levels—are finally happening.

Going Deeper With the Experts in Cannabis M&A

The motivations, circumstances and design of M&As are varied and diverse. And the structure of any M&A transaction will reflect that diversity. Guidance from experienced legal counsel is essential to ensure that all parties get the best outcome possible. We are here to share updated cannabis M&A intelligence and advisement, and support your business needs.



Laura A. Bianchi, Partner, Bianchi & Brandt

Founding partner of Bianchi & Brandt, Laura A. Bianchi is widely recognized as one of the nation's foremost experts in cannabis law, compliance, operations, corporate mergers and acquisitions, and strategic expansion. Having begun her work with the 2010 passage of Arizona's medical marijuana law, Laura was one of the first attorneys in the country to focus on the nascent legal cannabis industry. She continues to be admired for her leadership, as well as her powerful and steadfast advocacy for women in business.

With her vast industry knowledge, depth of experience, and reputation for meticulous attention to detail, Laura pioneered a holistic approach to providing business and legal services, partnering with her clients to navigate the complexities and challenges, unique to highly regulated industries. Laura represents individuals as well as private and public companies, providing advice and guidance at every stage of development, from applications and start up, through operations, to continued growth, expansion, and exit. She has amassed unparalleled real-world experience, serving clients both on a national and international level, closing transactions valued in the hundreds of millions of dollars.

Justin M. Brandt, Partner, Bianchi & Brandt

Founding Partner Justin M. Brandt is an award-winning business attorney focused on advising and nurturing the success and growth of our clients in the heavily regulated cannabis industry. The end-to-end strategic consultation he provides for business development ensures that clients become partners and advisees well positioned to grow and scale aligned with a shared vision of success. Justin commands a deep understanding of the industry, the players and the regulatory environment. He frequently represents multistate cannabis operators, dispensaries, cultivation and processing operators, and other cannabis-related businesses. Justin has also forged trusted relationships with regulators due to his years of experience navigating the nuanced facets of the cannabis sector.

The credibility and integrity he brings to the cannabis industry place him at the forefront of thought leadership, and he frequently presents as an authority on legal and business challenges facing the still-developing market. In addition to his cannabis-sector expertise, Justin is a leading industry and policy expert on the highly regulated emerging psychedelics market, as some of the formerly criminalized substances find mainstream cultural and commercial acceptance.

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