

BUSINESS VALUATION UPDATE

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Update on U.S. Cannabis Valuations From PKF's Practice Leader

"A one-time, historic opportunity," says Noam Hirschberger, CVA, CFA, describing the burgeoning cannabis industry. Hirschberger leads the cannabis practice niche set up last year at New York City-based PKF O'Connor Davies, and he recently spoke at a ASA NYC Chapter dinner. His presentation made it clear that rapid growth and heavy regulations have triggered a need for financial and advisory services, including valuation and tax planning, that will be critical to the ongoing success of firms in this industry.

The cannabis market has hit \$19 billion in the U.S., and one report¹ published by ArcView Market Research and BDS Analytics last summer predicted that global industry revenues will top \$40 billion by 2024. Over 30 U.S. states have legalized cannabis for either medical or recreational usage (or both), and major developments are happening regularly, so it's important for the practitioner to keep up with the industry and understand its nuances, Hirschberger notes.

The cannabis practice area at PKF specializes in providing valuation, audit, and tax minimization strategies (due to Section 280E and other standard tax issues) and services for cultivators, dispensaries, lifestyle brands, and private equity firms with cannabis companies in their portfolios. They also do fair value work (purchase price allocations) and valuations of licenses. Hirschberger's background is in valuation, and he has extensive

experience serving the cannabis industry. There are between 20 and 30 professionals at the firm who work in this area.

Challenges new and old. The industry has had its share of challenges, but a new one cropped up last summer when it became embroiled in the country's "vaping crisis." Hirschberger points out that, although vaping is an issue within the illicit market rather than legal cultivators and distributors, the entire industry was impacted. Education efforts to explain the differences between legitimate and illicit vaping products became more important, and the crisis is "starting to blow over," he says.

Ongoing challenges include the fact that, while many U.S. states have legalized cannabis, it remains illegal at a federal level, classified as a Schedule I substance, meaning that it has the "most potential for abuse and dependence and no medical qualities," according to the government's official definition. A big obstacle that this causes is that cannabis cannot be legally transferred between states, which means a company cannot achieve optimal economies of scale. "That needs to be taken into account in your projections," says Hirschberger. The inconsistency in state laws may be remedied with the "States Act," pending legislation that would amend the Controlled Substances Act and exempt state-approved marijuana activity from federal enforcement.

Another problem is that many banks are reluctant to deal with cannabis money, so legal cannabis businesses are often forced to deal in cash only. Having piles of cash leaves dispensaries open to

¹ markets.businessinsider.com/news/stocks/new-report-global-legal-cannabis-markets-to-grow-36-in-2019-despite-2018-challenges-to-break-40-billion-by-2024-1028294493.

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security concerns and risks of money-laundering issues, he says. But the banking issue is likely to be eased because a federal bill (Safe Banking Act) allowing cannabis vendors to work with regulated banks passed the House and has moved onto the Senate. Republican senator Mike Crapo, Senate Banking Committee chairman, notably shifted his position and provided vocal support for the legislation. With a landslide victory in the House, the next stop is the Senate, where it may not get the same reception. Plus, the ongoing impeachment proceedings could delay action on the bill.

The 280E problem. Tax optimization is a key service for clients because of the IRS' prohibition on taking tax deductions for business expenses related to marijuana because of its status as a Schedule I controlled substance. Under Section 280E of the tax code, no tax deduction or credit is allowed for any amount paid or incurred if the trade or business consists of trafficking in controlled substances prohibited by federal or state law. A deduction is allowed for cost of goods sold, but not being able to deduct operating expenses means it is possible for a cannabis company to pay more in taxes than it makes in profit, Hirschberger points out.

To help cannabis companies with this tough tax restriction, practitioners can help clients justify putting as much as possible into cost of goods sold. The trouble is, the IRS has not been forthcoming with guidance in this area, so it's a risky area. "Plant-touching" cannabis companies are subject to 280E, but it's not clear whether it applies to firms that provide ancillary services to this industry (e.g., testing services).

Guideline firms. There are a number of public multistate operators in this industry, which are American companies that are registered on the Canadian exchange because of better access to capital, such as Curaleaf, Acreage, Harvest, and Ianthus. For example, Curaleaf is based in Boston, and all of its operations are in the U.S. even though it raised capital in Canada, notes Hirschberger (PKF is the auditor for Curaleaf,

which had a market cap of \$4.8 billion as of September 2019). There is a set of Canadian public companies referred to as “licensed producers” such as Canopy Growth, Aurora, Aphria, and others. These firms have operations, such as cultivation facilities and dispensaries, in Canada. Be careful, though, if you look to use these Canadian companies to value a U.S. firm. “The macro-economic environment in Canada is very different from the U.S.,” Hirschberger says. These firms are not subject to the 280E issue, and they can sell anywhere in the country as well as export to other countries, unlike a U.S. operator. When looking for guideline firms, consider transaction prices in the same state and with similar types of assets, he advises.

Top three questions. At the outset of approaching an engagement to value a cannabis firm, here are three questions Hirschberger advises that you ask:

1. Is the subject company a plant-touching firm or does it provide ancillary services? This has tax implications (280E) that must be considered in projections.
2. What type of assets does the firm have? Are they for cultivating, dispensing, or manufacturing? Are there any intangibles or intellectual property, such as management contracts, licenses, brands, or patents?
3. In what state is the subject firm located? In some states, values can hinge on how many licenses the state has issued for cannabis companies. For example, Connecticut has issued very few (only four) licenses to cultivate, which drives up the license value considerably.

For more information. PKF has a recent white paper, “Cannabis: An Industry Growing in Every Sense,” which is available on its website.² Also, BVR provides several publications for business valuers practicing in this industry: “Cannabis and Hemp Valuations: A Market Analysis” (a BVR Briefing),³ *The Cannabis Industry Appraisal and Accounting Guide*,⁴ and *What It’s Worth: Value and Business Challenges in the Budding Cannabis Industry*.⁵ BVR also carries the ArcView guide, *The State of Legal Cannabis Markets*, 7th edition.⁶

2 pkf.com/media/10044862/cannabis-pkf-whitepaper.pdf.

3 bvresources.com/products/cannabis-and-hemp-valuations-a-market-analysis.

4 bvresources.com/products/the-cannabis-industry-accounting-and-appraisal-guide.

5 bvresources.com/products/what-its-worth-value-and-business-challenges-in-the-budding-cannabis-industry.

6 bvresources.com/products/the-state-of-legal-marijuana-markets-7th-edition.

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