

Cannabis Industry Status, November 2017

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Beginning January 1, 2018, two new cannabis taxes will be in effect in California:

- A 15 percent excise tax is imposed upon purchasers of cannabis and cannabis products. Retailers are required to collect the excise tax from the purchaser and pay it to the cannabis distributor.
- A tax on the cultivation of cannabis that enters the commercial market is imposed upon cultivators. Cultivators are required to pay the cultivation tax to either a distributor or a manufacturer depending upon the nature of the transaction. The cultivation tax rates are:
 - \$9.25 per dry-weight ounce of cannabis flowers, and
 - \$2.75 per dry-weight ounce of cannabis leaves.

Additional categories and rates may be specified at a later date. This article is the first of a three-part series discussing the Cannabis Industry.

Tax Revenue Implications

The legal cannabis industry reached \$7 billion in sales in 2016 and generated half a billion dollars in sales taxes, according to Reuters. States like Colorado have been able to use this relatively new source of revenue for infrastructure and other expenses. In 2015, Colorado collected more than \$135 million in taxes and fee on medical and recreational marijuana. Sales in the state totaled over \$996 million. Sales in North America grew 30%, to \$6.7 billion, in 2016, and are projected to increase to \$20.1 billion by 2021, according to Arcview Market Research. California, which is much larger in size and population than Colorado, could exceed \$15 billion in sales revenue and \$3 billion in tax revenue, according to an April 2016 study by ICF International.

Economic Impact

The legalization of cannabis in California has the potential to significantly benefit the state's economy. According to an ICF International report, California could consume between 1,302 million and 1,654 million grams of cannabis per year if recreational cannabis use is legalized, which amounts to between 1,435 and 1,824 tons, respectively. California sales revenue is estimated between \$15.9 billion and \$20.2 billion per year. Using the California

sales tax base rate of 7.5 percent, these sales revenue estimates amount to tax revenue between \$1.2 billion and \$1.5 billion per year. These tax revenue estimates are likely to double to at least between \$2.4 billion and \$3.0 billion per year.

Supply and Demand

Quantifying supply and demand of cannabis use in California is difficult due to the history marijuana has had with the law. As an illegal drug, data on activities related to cannabis use, its transportation, and growth is historically absent or scarce. Although the medical marijuana laws have been in place in California since 1996, the scale of California's population, when combined with their huge economic value, puts the state in a precarious position. A major issue is that California cannabis growers have been oversupplying more than the industry in the state will demand, months before recreational licensing is expected to begin – highlighting the state's massive unregulated market and illegal cannabis exports.

According to an economic report on cannabis cultivation published by the California Department of Finance in January 2017, the supply of cannabis in California meets demand more than five times. Demand by weight in California is estimated to be between 2.2 and 2.6 million pounds per year. This would imply, as a whole, California currently produces between 10.9 and 11.3 million pounds of cannabis, which will not be used by residents of the state. Of course, this estimate does not include potential from tourism and users who use more than 21 grams per month. In total, the Department of Finance estimates 14.2% of Californians have used cannabis in the last year, or 5.6 million residents. The report estimates as much as 13.5 million pounds of cannabis is grown in California, up 4.9 million pounds since 2006.

In a report published by ICF, it was estimated that approximately 19% of California residents have used cannabis in the last year, increasing the number of users in California to 7.7 million. Annual demand estimates range from 2.9 million pounds to 3.69 million pounds, an increase of at 700,000 pounds, at a minimum. Tourism, the report suggests, would add between 212,000 and 241,000 pounds of cannabis demanded each year.

Surplus supply and less demand for cannabis in California is estimated to yield billions in direct sales revenues, as well as billions in secondary industries (such as security, transportation, growing, and farming equipment, and in the black market. At an average market rate of \$1,500 per pound, as defined in the California Department of Finance report, California can expect between \$3.3 billion and \$5.55 billion in sales from residents each year and as much as \$361.5 million from visitors.

Risk and Uncertainty

Currently, the perceived risk and uncertainty in the Cannabis industry is enough to keep Wall Street money out of the Cannabis business. Most banks still avoid the cannabis industry

because of burdensome and costly federal regulations aimed at preventing money laundering. Approximately 301 banks and credit unions now do business with the industry – less than 3 percent of the nation’s financial institutions, according to Arcview. Additionally, Internal Revenue Service rules also prohibit growers and sellers from writing off normal business expenses, such as marketing, involving anything "associated with selling illicit substances." As a result, legal cannabis businesses pay effective tax rates of up to 70 percent. Lastly, uncertainties about whether the Trump administration will implement enforcement in the 29 states that have legalized medical or recreational cannabis hang over the industry.

According to US News and World Report, many opportunities have been created for new players such as MedMen, whose private equity funds provide a way for smaller investors with a tolerance for risk to capitalize on an industry that financial services firm Cowen & Co. projects should reach \$50 billion by 2026. Additionally, the first quarter of 2017 included 16 capital raises totaling \$56.5 million. \$51.7 million went to public companies, and the remaining \$4.8 million, to private corporations. Equity raises provided 77.5 percent of the total money, while debt raises only accounted for \$12.7 million.

Industry Trends and Challenges

The implementation of the new cannabis tax in California will significantly impact real estate, agricultural technology, social media, and consulting. Current industry trends in the cannabis space include: (1) investments made by partners of private equity funds and institutions, (2) establishment of new funds by family offices; (3) growth of new “unicorns”: and (4) IPOs in Canada which will raise money for US investing. Lastly, challenges that the cannabis industry faces include: (1) inexperienced management teams; (2) thinly capitalized companies; (3) uncertain regulatory environments at the federal and state level; (4) lack of established, experienced players; (5) stigma of cannabis as a "dangerous drug" and criminal.

Sources:

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