

Raising Capital and Investing in the Cannabis Industry

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Canada's move towards legalization of cannabis in summer of 2018 makes it uniquely positioned, relative to the United States, to be at the forefront of cannabis commerce and a leader in attracting investment in its cannabis industry.

Currently, the majority of equity capital for cannabis businesses in both Canada and the U.S. is being raised by boutique investment banks. While initially investors in the cannabis industry included individuals and a limited number of small venture capital and private equity funds, larger established funds have recently begun to turn their attention towards the industry. Whether venture capital firm, institutional investor or startup, those seeking early-mover benefit in the "green rush" will want to thoroughly assess their investment mandates, regulatory concerns, and other considerations.

Current Legal Landscape

Cannabis Regulation in Canada

In Canada, the production, cultivation, and sale of cannabis for recreational use is currently illegal. However, if strictly for medicinal purposes and under physician prescription, personal cultivation for medical use and the production, cultivation and sale by licensed medical producers is permitted and regulated under Canada's *Access to Cannabis for Medical Purposes Regulations* (ACMPR).¹

Legislative reform to legalize recreational use, cultivation and sale has been progressing since the Liberal Party of Canada promised legalization during the most recent federal election. On April 13, 2017, the Liberal government introduced the first reading of the bill (Bill C-45) to the House of Commons, which proposes to provide legal access to cannabis, and many analysts and news sources report that the legal sale, cultivation and use of recreational cannabis is expected by the summer of 2018.^{2 3} Despite this expeditious plan, Secretary to the Minister of Justice and head of the legalization effort William Blair indicated on numerous occasions that timelines are merely speculative and that while the government will keep its promise to legalize cannabis, it is committed to taking the time to do it right, citing the need to develop sound regulations and negotiations with the provinces and territories.⁴ Further, it has been suggested that the federal government decriminalize possession of non-medical cannabis for personal use until such legislation is passed (though in our view this is unlikely to occur).⁵ The Canadian 2017 budget provided little insight into the proposed legislation or timeline, but stated that in regulating the industry, the government "will take steps to ensure that taxation levels remain effective over time."⁶

There is a great deal of optimism surrounding the Canadian cannabis industry. According to Bill C-45, licenses issued under the ACMPR will be deemed to be licenses for the production, testing, packaging, labelling, sending, delivery, transportation, sale, possession or disposal of cannabis, including recreational cannabis, issued under the proposed

Cannabis Act. Accordingly, many companies are applying for licenses to produce medical cannabis under the ACMPR in an effort to gain a “first-mover” advantage over their unlicensed counterparts.⁷ However, as of March 2017, Health Canada had only approved approximately 2.6% of applications received under the ACMPR.⁸

For more detail on cannabis regulation in Canada, including insights from the report issued by the Task Force, please see Torys’ related articles:

- [Breaking Ground: Canada’s Cannabis Framework](#);
- [Paving the Way to Cannabis Legalization](#); and
- [Legislative History of Medical Marijuana in Canada](#).

Cannabis Regulation in the U.S.

Under U.S. federal law, cannabis is a Schedule I drug under the *Controlled Substances Act*.⁹ In short, the drug’s Schedule I status means cannabis is illegal under U.S. federal law, regardless of conflicting state laws.¹⁰ However, in December 2014, the Rohrabacher-Blumenauer amendment was passed in the House of Representatives prohibiting the Department of Justice from spending funds to interfere with the implementation by states of their own laws that authorize the use, distribution, possession, or cultivation of medical cannabis. The amendment is set to expire on September 30, 2017. Since the passing of the Rohrabacher-Blumenauer amendment, the use of both recreational and medicinal cannabis has been legalized in eight states as of the date of this article.¹¹ While President Trump has publicly stated that he will comply with the Rohrabacher-Blumenauer amendment, there is nonetheless great uncertainty surrounding the U.S. cannabis industry due to the lack of a long-term solution to conflicting federal and state laws and previous signaling by the administration of a crackdown on enforcement of federal drug laws.¹² If this trend continues, Canadian producers of cannabis products may be well situated to attract capital from local and foreign investors looking to get in on the recreational cannabis industry, which is projected to generate an annual \$5 billion in sales, before factoring in ancillary market products and services.¹³

Raising Capital and Investing in the Cannabis Industry

Traditional Financing

As a result of illegality, access to capital from traditional lenders has been a major challenge for cannabis cultivation operations and other cannabis-related businesses in both the U.S. and Canada. However, given the clear path to legal recreational use in Canada, traditional lenders in Canada have begun making loans to businesses in the cannabis industry and will likely also begin to provide commercial and investment banking services. In the U.S., so long as cannabis remains an illegal substance under federal law, traditional lenders in the U.S. will almost surely stay clear of the cannabis industry unless there is clear guidance in writing that federal authorities will not enforce federal laws in states that have legalized recreational and medicinal cannabis.¹⁴ As it currently stands, federal authorities in the U.S. have the power to close a cannabis dispensary and seize its assets notwithstanding that such dispensary may be legal under applicable state law. While Canadian lenders have begun providing financing to cannabis businesses, to the extent that they have significant operations in the U.S., they may be unwilling to provide cannabis businesses with financing or basic banking services so as not to jeopardize their U.S. operations or potentially violate anti-money laundering law.

Private Equity and Venture Capital

For the reasons outlined above, until now the majority of established venture capital and private equity funds have generally been hesitant to invest in the industry. While these funds are beginning to show greater interest and are finding ways to structure around the risks of investing, most cannabis businesses have historically relied on investments by small venture capital, private equity funds and high-net-worth individuals. Smaller funds are willing to

assume the risk that their portfolio companies could be subject to changes in regulation in exchange for the value proposition that their portfolio companies will have a head start compared to other companies or will be merged, acquired or partnered with other companies in the supply chain.

Mainstream venture capital and private equity funds looking to invest in the cannabis industry should consider ways to structure cannabis investments to address the concerns of their institutional investors.

Such venture capital and private equity funds will typically invest through fund investment vehicles which are structured like traditional private equity funds and established for the purpose of investing solely in cannabis or cannabis-related businesses.¹⁵ A survey of such funds shows that targeted capital commitments currently range from US\$25 million to US\$125 million with capital being sourced from high-net-worth investors or family offices, often through cannabis specific investment funds.¹⁶ Venture capital and private equity funds are using innovative branding and marketing tools to tackle the stigma associated with cannabis to attract investors. These firms should be prepared to address stricter confidentiality requests from investors who may have reputational concerns associated with investing in the cannabis industry.¹⁷ A survey of cannabis-sector investment funds shows that investments are being made across numerous verticals within the cannabis industry, including cannabis and related accessories, medical cannabis, technology platforms and software and cannabis information resources.

Some venture capital and private equity funds making equity investments in cannabis businesses will also provide loans, but at relatively high interest rates. In some cases, the loan has been structured as convertible debt allowing the fund to convert the loan into an equity stake in the company at a future date. In the U.S., it should be noted that to the extent a cannabis business' activity violates U.S. federal law, such business has no entitlement to federal bankruptcy protection (even though its operations may be legal under applicable state law), meaning lenders may have difficulty obtaining repayment.

Large mainstream U.S. and Canadian institutional investors, including pension funds and endowments, are among those investors largely evaluating the cannabis industry from the sidelines. While there have been some early-mover institutional investors in this industry, for many others, investments in cannabis may not be consistent with their investment mandates, particularly as it relates to risk tolerance. In addition, it is not uncommon for institutional investors to be prohibited from investing in portfolio companies that derive revenue from activities such as gambling, pornography, tobacco, alcohol or munitions. Institutional investors will generally negotiate excuse rights with respect to investments in portfolio companies that contravene such investment policies, which are typically set out in the side letters that investors negotiate alongside the limited partnership agreement of the fund.

Mainstream venture capital and private equity funds looking to invest in the cannabis industry should assess whether their institutional investors are subject to internal investment policies that would prohibit them from investing in cannabis and consider ways to structure cannabis investments to address the concerns of their institutional investors, including through the use of side letter provisions to address confidentiality, reputational risk and other concerns (and, where necessary, by granting excuse rights).

Public Capital Raises by Established Licensed Producers

Despite the hesitation among certain investor groups, established Canadian licensed producers of medical cannabis are also turning to the public markets to finance operations. These established licensed producers are taking advantage of the increased demand for cannabis investment opportunities and the high valuations associated with the capital raises by licensed producers are likely tied to the expectations that such licensed producers will ultimately enter the recreational market once legalized. These capital raises are typically led by boutique investment banks who have dominated the industry.

Canopy Growth Corp. (TSX:WEED) (Canopy) is the first Canadian marijuana company to surpass the \$1 billion market cap. It moved from the TSX Venture Exchange (the TSXV) in July of 2016 and it has received significant attention from investors as one of the first producers to receive official licensing from Health Canada. Demonstrating further momentum, Aphria (TSX:APH), another Canadian licensed producer of cannabis, upgraded from TSXV and joined

Canopy on the TSX on March 23, 2017. Moreover, following Aphria's upgrade to the TSX, it announced on April 20, 2017 that it had raised \$100 million for funding continued expansion of its production facility, comprised of \$75 million in bought equity financing and a \$25 million loan from the WFCU Credit Union.

Conclusion

The emerging recreational cannabis industry presents enormous opportunity for venture capital and private equity funds, and more recently, large institutional players, particularly in Canada which is poised to be a leader in cannabis commerce. Those investing in the cannabis industry today have the opportunity to benefit from an early-mover advantage, but at the same time must be ready to properly address the potential regulatory and other risks associated with such investments.

¹ [Access to Cannabis for Medical Purposes Regulations \(2016\), SOR/2016-230 \("ACMPR"\)](#)

² [Bill C-45, An Act respecting cannabis and to amend the Controlled Drugs and Substances act, the Criminal Code and other Acts, 1st Sess., 42nd Parl., 2017. \(first reading 13 April 2017\)](#)

³ [The Canadian Press. "Liberals introduce long-awaited bills to legalize marijuana by July 2018" National Post 13 April, 2017](#)

⁴ [Slerritt, Jen, and Josh Wingrove. "Marijuana Stocks Drop as Trudeau's Pot Czar Says Canada Won't Rush into Legalization." Globe and Mail 7 Mar. 2017; Interview of MP Bill Blair by Don Martin \(March 27, 2017\) on Power Play, CTV News Channel](#)

⁵ [Powell, Betsy. "Toronto's public health chief wants pot possession decriminalized now." The Star 5 June 2017](#)

⁶ [2017 Federal Budget](#)

⁷ [ACMPR, supra note 1](#)

⁸ [Babad, Michael. "There Won't Be Enough Pot to Go around When It's Legal in Canada." Globe and Mail 30 Nov. 2016](#)

⁹ [Controlled Substances Act \(1970\), U.S.](#)

¹⁰ [Cano, Catherine A., and Kathryn J. Russo. "Seven States Pass New Marijuana Laws on Election Day." Jackson Lewis LLP Publications. 16 Nov. 2016](#)

¹¹ Alaska, California, Colorado, Maine, Massachusetts, Nevada, Oregon and Washington

¹² <http://www.businessinsider.com/medical-marijuana-trump-administration-2017-first-statement-2017-5>

¹³ [Recreational Marijuana - Insights and Opportunities. Rep. Deloitte, Oct. 2016.](#)

¹⁴ "Legal pot is still a tough deal for investors." Pharma & Healthcare Monitor Worldwide. 3 November 2016.

¹⁵ Benjamin, Jeff, "Asset manager sees gold in grass' starts PE pot fund," Investment News. 25 May 2015.

¹⁶ Huddleston, Tom, "Private equity fund raises \$100 million for cannabis startups," Fortune. 4 Nov 2016.

¹⁷ Frean, Alexandra, "Big-time investors take a deep breath and dive into America's latest growth industry," The Times. 14 May 2016.