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# CANNABIS FUNDS: HIGH ON RETURNS OR JUST HIGH?

Marni Pankin, Assurance Partner in Marcum LLP's Alternative Investment Group, analyses the risks and other considerations when launching and investing in cannabis funds.

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## Cannabis Funds: High on Returns or Just High?

An interview with Marni Pankin

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### Q What factors are driving investments in cannabis funds?

**A** Cannabis, as it transforms from a black market of street corners and shady characters to a regulated, high profile global industry crossing into healthcare, wellness and adult recreation, is providing investors with a new and exciting, and, some say, short-lived investment opportunity. In spite of the federal prohibition (or for those in search of alpha, perhaps because of it), investing in cannabis companies has gone beyond the initial supporters and now includes hedge funds, private equity funds, and even initial public offerings on the NASDAQ. As of June 2019, 38 states and the District of Columbia have passed laws legalising marijuana in some form, and 11 states plus D.C. have adopted expansive laws legalising marijuana for recreational use. State legalisation has fuelled explosive growth in this market.

According to a report by Grand View Research, Inc., the US legal cannabis market was valued at \$11.9bn in 2018 and is anticipated to expand at a CAGR of 24.1% from 2019 to 2025. The investment community is enthusiastic about this new asset class, and high-net-worth and institutional investors want in. Many predict that marijuana will become legal at the federal level within the next five years. Once that happens, and big pharma and tobacco companies enter the market with their substantial financial resources, political influence, and brand names,

investment returns and opportunities will likely shrink for cannabis investors. Most say that now is the time to go green.

### Q Are some investing solely in cannabis or using it as one part of their portfolio?

**A** I've seen several hedge funds in the healthcare space gravitate towards cannabis investments. Multistrategy managers, excited about the growth, also are making investments in new listed companies. I would caution investment managers to ensure these are permitted investments per the fund's mandate and the risks are fully disclosed. Investing in cannabis involves legal, regulatory, and operational risks that are unique from other industries. Legislation and enforcement is continually evolving, US banking challenges persist, and Section 280E tax rules continue to severely limit the deductibility of cannabis company expenses. Launching a cannabis concentrated fund will allow a manager to take the time to fully understand these risks and challenges, establish protocols to mitigate them, and provide complete disclosure to potential and existing investors. Further, while the lack of industry diversification will increase portfolio and market risk, I believe having a concentrated cannabis fund allows for a more transparent communication of the investment objective to potential investors.

**Q What types of investment entities do you see in the cannabis space?**

**A** The Delaware limited partnership or LLC set-up of a private equity fund with capital commitments, calls and a limited life is most commonplace for those investing in new venture capital and start-up companies. For investments in public companies, a hedge fund structure, which allows for more investor liquidity, could be suitable. However, be sure to include side pocket terms for private placements, warrants, convertible debentures, and other restricted and illiquid securities, which are expected in this new market. These investments should be ring-fenced from the general population of freely traded cannabis stocks.

A new manager will typically begin with a 3(c)(1) fund, which permits a small percentage of nonaccredited friends and family to invest along-side the accredited investors. However, these investor slots, limited to 100, quickly fill up. In several instances, I've seen the need to open a parallel 3(c)(7) fund, which allows up to 2,500 investors, all of which must be qualified purchasers (\$5m net liquid worth minimum). Any qualified purchasers from the 3(c)(1) would be transferred into this new fund.

The longer the raise period, the greater the chance for operational and accounting complexities, as all the investments purchased need to be split and transferred, and expenses incurred since inception need to be reallocated each time new investors commit. Some considerations are whether catch-up interest should be charged to late-comers, how the transfers impact the IRR calculations for each fund, and whether restrictions at the portfolio companies preclude transfers between the two funds. If so, it may make sense to create an SPV to purchase the investments, of which each fund will own a participation.

**Q Why are some still cautious about this segment?**

**A** . The possession and sale of cannabis remains illegal under federal law. In 2018, the US Attorney General rescinded the Cole Memorandum (the "Sessions Memorandum") that had previously adopted a general policy of non-interference with

cannabis-friendly state laws. The Drug Enforcement Agency (DEA) reiterated its classification of cannabis under the Controlled Substances Act (CSA) on its Schedule I list of drugs that have no medical use, a potential for abuse, and are unsafe to use even under medical supervision. If the US government enforces federal laws prohibiting cannabis, the current and potential business prospects and results of operations of cannabis companies could be adversely affected. Additionally, should the federal government legalise cannabis for medical or recreational use, it is likely that federal agencies will issue rules and regulations related to the cultivation, processing, marketing, and sale of cannabis. This can lead to additional costs, operating requirements, and possible restrictions imposed on a fund's portfolio companies. If any portfolio companies are found to be in violation of federal law, there is a risk that a fund may also be subject to prosecution and/or monetary fines. A fund's investment in a cannabis business could, therefore, be subject to losses or even asset forfeiture, including proceeds derived from its activities in the cannabis industry.

Further, the Financial Crimes Enforcement Network (Fincen) 2014 Guidelines relied on the Cole Memorandum to establish a safe harbor when filing a Suspicious Activity Report (SAR), by which a bank would admit to the federal government that the bank is violating federal drug and anti-money-laundering laws when transacting in cannabis-related activities. Without the Cole Memorandum's safe harbour, a banking institution servicing cannabis companies risks regulatory scrutiny and federal prosecution. Until federal statutes or administrative guidance provide more regulatory clarity, the Sessions Memorandum increases cannabis-banking institutions' exposure to federal enforcement. This uncertainty, in turn, could adversely affect the ability of a fund or its portfolio companies to be provided banking services. Further, the lack of credit available to these entities may reduce the ability of the fund to raise or deploy capital and for portfolio companies to sustain their cannabis-related business.

### **Q Why are cannabis investments hard to value?**

**A** Funds following generally accepted accounting principles are required to value their portfolio investments at fair value, which is the estimated price at which an asset could be bought or sold in a current transaction between willing parties. For private and less liquid cannabis investments, valuation can certainly be a challenge. While multiple valuation approaches should be considered, some methods may not be appropriate due to limited industry benchmarking data, small company capitalisations, and lack of financial reporting and reliable financial projections. For instance, using a market approach has limitations, as guideline public companies may not be comparable businesses, exponential growth and speculation have skewed valuations, and public transaction data is limited. New cannabis companies typically have negative EBITDA, so enterprise values need to be computed using revenue multiples, which are less comparable. For venture capital and pre-revenue companies, a recent round of financing is often used to estimate the current value; however, the latest raise may not be at arms-length or may not be representative of the fund's holdings. A more complicated back-solve method using an option pricing model that considers the economic rights and preferences unique to each class of stock may be more appropriate. A discount cashflow model could provide a reasonable valuation, but projections in start-up companies with shorter operating histories on which to judge future performance are inherently subject to uncertainty and inaccuracies. Further, discount rates are highly subjective with wide ranges that include both industry and company-specific risk premium factors.

I encourage my clients to establish robust valuation policies for all possible investment types along the capital structure. Fund entities should refer to the AICPA's new guide, Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies, which provides non-authoritative guidance and illustrations regarding the accounting for and valuation of portfolio company investments held by investment funds. The guide addresses valuation issues including transaction costs, calibration, the impact of control and marketability, and back-testing to consider

when estimating the fair value of investments. Consideration of employing independent valuation specialists and using a valuation committee to weigh in on sensitive valuation decisions (such as buying or selling investments from/to related parties) should also be given when implementing valuation policies and procedures.

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*Marni Pankin is a partner in Marcum LLP's Alternative Investment Industry group, responsible for advising clients on the formation and operation of investment funds. Pankin provides guidance on complex accounting areas such as fair value measurements, revenue recognition, derivative disclosures, consolidation and merger/recapitalisation transactions. A frequent presenter at industry conferences, Ms. Pankin currently serves as the editor-in-chief for the firm's alternatives-focused newsletter, Private Investment Forum.*

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