Investing in Weed: Is It Time?

By The Financial Poise Editors | February 13, 2024

When marijuana started to become legalized in some states, budding startups in the space began to proliferate, and many investors saw this new space as an opportunity. For a host of reasons, not the least of which was and remains the legal/regulatory risk involved, most startups in the marijuana and cannabis spaces were either bootstrapped or funded by venture capital. The times they are a-changin', as the American poet Robert Allen Zimmerman once wrote. Is it time for traditional private equity and others to look more deeply at investing? That depends on who you talk to — and when.

> **Editors' Note:** There is a lot of confusion as to nomenclature in this space. Here's what you need to know:
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> The word "cannabis" refers to all products derived from the plant Cannabis sativa.
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> The word "marijuana" refers to parts of or products from the plant Cannabis sativa that contain more than .3% of tetrahydrocannabinol ("**THC**")
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> The word "hemp" means cannabis that contains 0.3% or less THC content by dry weight.
>
> The above are legal definitions, not scientific ones.
>
> Other names for marijuana include Aunt Mary, BC Bud, Blunts, Boom, Chronic, Dope, Gangster, Ganja, Grass, Hash, Herb, Hydro, Indo, Kif, Mary Jane, Mota, Pot, Reefer, Sinsemilla, Skunk, Smoke, Weed, and Yerba. None of these are legal terms.

Pot's First Boom and Bust

For Brendan Kennedy, CEO of Seattle-based PE firm Privateer Holdings Inc., it wasn't difficult to find investors to fund marijuana-based ventures in 2018.

The early "pot boom" led Kennedy and his fellow Privateer founders to become billionaires after investing in the Canadian cannabis firm Tilray Inc. The Government of Canada legalized cannabis in 2018, and by September of that year, Tilray's market value topped $21 billion — a growth of nearly 550% in one month.

However, the growth in this case proved to be too far, too fast. By October, Tilray's value plunged and began a steady decline that many experts say still hasn't stopped. Tilray stocks fell from $300 per share in September 2018 to $70 by year's end. The company's market value was roughly $1.8 billion in late 2023, a drop reflective of the market as a whole.

According to S&P Global, in 2022, the aggregate value of private equity deals in cannabis declined 79% to under $800 million, down from about $3.82 billion in 2021. In the first quarter of 2023, deals totaled just $18 million.

Those keeping an eye on the market, including Gies College of Business professor Olga Khessina, attribute cannabis' troubles to increased competition, oversaturated markets, and drooping stock prices — in addition to the lack of federal legislation to help destigmatize the industry.

The Current Perception of Cannabis

While the stigma of investing in a federally prohibited product continues to scare financial institutions away, public perception has changed dramatically in recent years.

As of 2023, according to the National Council of State Legislatures, 38 states, three territories, and the District of Columbia have made medical marijuana legal within their own jurisdictions. Additionally, 24 states, two territories, and the District of Columbia have legalized the recreational use of marijuana.

Right, wrong, or indifferent, as hundreds of millions of dollars are pouring into the business of marijuana, a Schedule I drug under the Controlled Substances Act, the federal government isn't standing by idly while the country goes to pot. It's a clear emerging investment trend that isn't as controversial to most of America as you may have thought.

Recent polling from Pew Research shows a growing acceptance of cannabis. As of October 2022:

- Nearly 90% of Americans support the legalization of marijuana for medical or recreational use, with 59% supporting both uses and 30% for medical use only.
- Roughly 72% of Gen Z, 62% of Millennials, 54% of Gen Xers, and 45% of Baby Boomers believe marijuana use should be legal.
- 73% of Democrats and 45% of Republicans support legalization.

Normalization of marijuana continues to push legislation toward legalization, including the August 2023 recommendation by the Department of Health and Human Services (HHS) to reclassify marijuana from a Schedule I substance to a Schedule III. If this happens, it will have a substantial effect on private equity firms and other investors as they look to weed.

In addition to helping lift the industry's stigma, rescheduling would significantly impact how cannabis businesses are taxed. Currently, the

Schedule I classification results in an income tax rate as high as 80% for many cannabis businesses. And U.S. Revenue Code 280E prohibits businesses dealing in Schedule I and II substances from many federal tax deductions and credits. If marijuana is rescheduled, Code 280E will no longer apply to those businesses. And, of course, we can assume financial institutions would fling open their doors for financing and banking.

Until then, as a recent Bloomberg Law article states, “Unlike traditional financings, cannabis [read: marijuana] transactions need to get potential investors over the additional hurdle of investing in a federally illegal operation.”

Challenges and Opportunities in the Cannabis Space

As long as banks, merchant processors, and most SAAS companies won’t work with marijuana companies, most businesses will face operating challenges, affecting investors. But cannabis is not just marijuana.

Take the preternaturally competent duo of David Charles (age 33) and Jake Antifaev (age 26) of MOOD, an online dispensary featuring high-quality, hemp-derived THC products tailored to customers’ moods (hence, the name).

The two entrepreneurs excelled at different aspects of business before combining forces to create MOOD. Antifaev had experience in e-commerce, marketing, and the Canadian cannabis industry. Charles’ experience was more varied, though his primary roots were in tech and health tech. Together, they forged a new path in the e-commerce cannabis industry, offering federally legal smokables, edibles, and vapes from their warehouse in Oklahoma.

MOOD is an example (albeit, perhaps the most successful example) of a company that uses perfectly legal (under federal law and those of most states) hemp to create mood-altering consumer products with effects arguably similar to those of federally illegal marijuana. The company's smart marketing, transparency, consumer-focused website, and convenient shopping experience allowed the company to close in on $100 million annual revenue in 2023. According to Charles, MOOD anticipates a tripling of revenue in 2024.

While the marijuana industry is struggling, the broader hemp industry appears alive and well in the hands of industry participants like Charles and Antifaev. And because their product falls within federal law, the company doesn't face all the same hurdles as its marijuana cousins. Indeed, according to a recent *Whitney Economics Report,* hemp-derived cannabinoids were a $28 billion dollar industry in 2022 — on par with craft beer.

But it's not just about legalities. To paraphrase Charles, the business should be run like tech, not like weed. In an interview for the "*Proud to Work in Cannabis*" podcast, Charles credits his time in tech with instilling in him the right practices for sourcing, hiring, onboarding, training, measuring success, and setting realistic but aggressive team goals.

Charles notes the reason so many cannabis businesses fail is that "the space is largely devoid of institutional sophistication." Many players have little experience in running a real business. When highly sophisticated and skilled players like Charles and Antifaev enter the scene, the end result can be very different.

To allow the owners to maintain focus on the vision and control of the business, MOOD was bootstrapped and did not pursue outside investment capital. But potential investors and other entrepreneurs considering entering the cannabis market can take many a lesson from the company's success.

Demands on Marijuana Companies & Their Investors

There isn't much room for error in the highly regulated marijuana industry, especially for license-holding businesses that are "plant-touching," such as growers, manufacturers, and dispensaries. If investing in a startup, investors need to know the company's licensing, organizational structure, business plan, and staffing are solid.

In addition to the risks, regulatory requirements, and costs, and depending on the jurisdiction, investors might be on the hook for name disclosure and background checks. Not all investors are comfortable with a government record of their involvement in the marijuana space.

To avoid some of the red tape and ownership-related headaches, some investors may opt to support ancillary businesses to the cannabis industry that never touch the plant, such as technology, packaging, marketing, and security. Many of these services don't involve licenses and related ownership issues. However, depending on the state and local regulations, investors still need to know how local regulators view their involvement in any business that touches marijuana revenue, even tangentially.

In addition, marijuana investors might note that this booming *hemp-derived* business is competing directly with its red-tape-laden, banking-challenged competitors. However, the ground hemp stands on isn't rock solid, either. The 2018 Farm Bill expired on Sept. 30, 2023, and has been extended through Sept. 30, 2024. The new bill, planned for 2024, however, is not expected to have implications for hemp-derived products.

For many in the know, this sparks a bigger question of whether marijuana businesses should be learning how to coexist and, perhaps, merge with the hemp industry rather than fight it.

Is it Time to Go in on Ganja?

While some experts predict an oncoming uptick in investment activity since potential reclassification may unlock profitable new markets for marijuana companies, others remain wary.

Financial Poise believes that the prohibition against marijuana will eventually be history. However, until the federal government follows the lead of some states, extreme care should be taken before entering the space.

Jonathan Friedland, publisher of Financial Poise and a corporate attorney representing private equity funds as well as companies in both the hemp-derived and marijuana-derived cannabis spaces, explains that until federal regulation changes, marijuana companies continue to face enough risk that keeps his PE clients from looking marijuana.

"One should not lose sight of the fact that while some of these companies may blaze new trails, many early entrants into new industries don't succeed," Friedland stated. “If you’re my age, you may recall the Commodore 64 — that company went bankrupt in 1994. That’s essentially the case for a hundred computer startups that were not Microsoft and a hundred more search engines that were not Google. Investing in marijuana today is more appropriately viewed as a VC rather than a PE play. When the Feds act, we’ll see a lot more M&A activity involving PE and, for that matter, I would expect to see tobacco industry players to dive in deeper than they already have, any maybe some of the hemp-based cannabis companies.”

To Friedland’s point, there is currently no policy in place to prevent Big Tobacco from buying into the cannabis industry. In recent years, tobacco giants have been funneling money into weed and lobbying for pro-cannabis legislation. In late 2022, one of the world’s largest tobacco companies, British American Tobacco, invested $37.6 million into Snoop Dogg-backed Sanity Group and $91.3 million in Organigram, while Altria (formerly Phillip Morris) put $1.8 billion (a 41% equity stake) into Cronos Group and entered a deal worth $650 million with Israel cannabis firm Syqe Medical.

Does Marijuana Need a Vision Shift?

As previously noted, the hemp-derived hemp industry is flourishing, in large part due to its enjoyment of federal legality. And we’ve also learned that business-savvy hemp visionaries are creating and selling consumer-friendly products that cause an effect similar to marijuana. The marijuana sector sees this as competition to fight via lobbying.

However, many knowledgeable players are concerned less with the differences between marijuana and hemp and more with how marijuana businesses might need to start playing as if they are on the same team as hemp businesses if they want to survive.

Attorney and cannabis industry leader Robert Hoban recently published an enlightening [five-part series for *Forbes*, in which he details] why the marijuana industry needs to take a lesson from the federally legal hemp industry and join it rather than fight it. Consumer demand, Hoban reminds us, is what is driving the success of hemp-derived products. And consumer demand is what any successful industry should follow.

While the traditional marijuana industry sector has been spending time – and millions of dollars in revenue – lobbying against hemp, Hoban calls out the short-sightedness of such a fight. Consumers are proving that they want what the hemp industry sells. Hoban argues that hemp and marijuana should be focusing on collaborative policy that benefits the industry as a whole rather than marijuana waging what he calls a "civil war."

The Final Word (Today) on Investing in Cannabis

At the end of the day, marijuana is still a federally illegal product, a fact that continues to challenge business growth and make investment risky. And while stakeholders and interested parties wait for the government to change that fact, Big Tobacco is already poised to have an even larger presence on what was once a newcomer's stage. Hemp-derived cannabis, however, is a different story altogether.

We think you'll also like:

1. *Cannabis Companies and the Marijuana Tax: It's Not Easy Being Green*
2. *Blockchain & Cannabis: Investing Compliance*
3. *The Ins and Outs of a Venture Capital Investment*

[Editors' Note: *To learn more about this and related topics, you may want to attend the following on-demand webinars (which you can view at your leisure, and each includes a comprehensive customer PowerPoint about the topic):*

1. *Cannabis Law*
2. *Cannabis Investment: Successes, Failures & Strategies for the Future*
3. *Negotiating and M&A Deal*

*This is an updated version of an article originally published on June 14, 2019.**]***