

# Capitalizing on Cannabis: The Five Ps Necessary to Prosper in the Private Market

Alan Brochstein, CFA

The radical transformation of the cannabis industry, which is moving from a black market to a highly regulated one on a state-by-state basis, is creating tremendous opportunity for entrepreneurs. It's no secret that fantastic growth lies ahead, and many companies (over 300) have flocked to the stock market, catering to the demand from investors who want to participate in this ground-floor opportunity. Publicly-traded stocks, relegated almost entirely to the "penny stock" arena, can offer good liquidity but at valuations that are difficult to justify despite large price declines. Private investment in the cannabis industry comes at a significantly lower valuation, but investors must give up liquidity in order to participate, requiring careful due diligence before investment.

Already several institutions have announced or commenced funds dedicated to investing in the cannabis industry, and there are angel investor networks, crowd-funding platforms and accelerators as well. At [New Cannabis Ventures](#), we provide a [comprehensive list](#) of these organizations, and we expect the number to grow dramatically in the coming years.

Investing in private placements, while potentially providing better long-term returns for accredited investors (institutions and individuals meeting certain wealth or income minimums) than investing in public companies, requires a higher level of diligence than public companies due to the limited ability to exit an investment until the company is acquired or begins trading publicly. With cannabis illegal federally, the environment is not conducive to either of these avenues, suggesting that private investors in the cannabis industry need to take extra care in their research before making an investment. Here are five areas of focus that I recommend:

## **PEOPLE**

When it comes to investing in start-ups, there is an old adage about betting on the jockey rather than the horse, wise words for the cannabis industry. It is essential to understand the background of the key executives. What kind of track record have they enjoyed? Do their skill sets complement one another, or is the team skewed too heavily towards one attribute and lacking in another, including operations, marketing, finance. Experience within a larger organization offers potential benefits in terms of being aware of best practices, but start-ups require a different set of skills.

Investors in the cannabis sector should look for balanced management teams, with experience from both within the industry, which is always a good idea, but also from outside, given that the cannabis industry hasn't been exposed to many of the best practices given its historical operating circumstances.

LinkedIn profiles can be helpful in understanding the background of an executive, and one should also look into any key outside owners or lenders. Checking references is essential, and a background check on the principal members of the management team can serve as an extra layer of protection.

Finally, investors should give careful consideration to compensation and ownership. Ample skin-in-the-game with pay tied to clear financial metrics or to valuation creates a powerful alignment with outside shareholders.

## **PLAN**

Investors often pay attention first to the business plan, but a good plan with bad management is doomed for failure. Even with a good business model, management teams will be forced to adapt to a rapidly changing regulatory landscape. What works in one state may not work well in another, and newly developing markets will challenge any management team that thinks it has a crystal ball. Investors are likely to continue to delineate between direct cannabis investments (cultivation, dispensing) and ancillary goods and services.

## **PECUNIARY**

Companies in the start-up mode typically burn cash, and many of the entrepreneurs in the dynamic cannabis industry are new companies. Investors should have a good understanding of cash needs and potential burn rates and be prepared for potential dilution as the company seeks to raise more capital in the future. It is essential that the management team is realistic with its projections.

## **POLITICS**

Perhaps more than for any other industry, investors need to focus on the rapidly evolving political landscape. A great way to stay on top of things is to subscribe to [Marijuana Policy Project's](#) email list. This lobbying organization and its companion not-for-profit foundation have been leading the charge to reform laws since 1995. Another resource is the [National Cannabis Industry Association](#) (NCIA), the trade group representing the industry. NCIA hosts physical meetings for members throughout the year in a variety of locales in order to update on legislative and other matters. Each state has different ownership rules, and these rules may change over time. Investors should also remember that cannabis remains illegal and investing in companies in the sector may expose them to legal risk.

## **PORTFOLIO**

Proper portfolio management is essential no matter what type of investment one makes. In private investing, given the limited liquidity and the often binary outcomes of total failure or tremendous success, investors will typically limit an investment's contribution to the overall portfolio. When it comes to cannabis investing, diversification is an even more important attribute. Not only should investors focus on limiting the size of an investment relative to the total funds available for the industry, but diversifying across industries within the sector. Some investors will want to take ownership position in companies that directly "touch" cannabis, like growers, processors or dispensaries, while others may choose to focus exclusively on ancillary services. While certain states may require in-state residence in order to own equity, it is possible to structure investments as either straight debt or debt with equity kickers.

Investing in the cannabis sector offers investors the potential to get in on the ground floor of an industry in transformation, helping entrepreneurs looking to grow, process or dispense cannabis in a legal, regulated market, to offer technology or services to help with compliance, payment processing, yield improvement, or to provide ancillary goods and services that will be in demand as legal cannabis proliferates. For long-term investors, the private equity market likely offers better returns and higher quality companies than publicly-traded stocks at the cost of limited liquidity. Accredited investors choosing to prosper from the 'Green Rush' should pay attention to the 5 Ps.