MGO & ELLO

Cannabis Private Investment Review

Data provided by PitchBook

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Contributors

MGO | ELLO

MGO is a CPA and advisory firm that offers a suite of accounting and advisory services to help companies, investors, and government agencies navigate the complexities of the cannabis market. Through a strategic alliance with ELLO—a cannabis business ecosystem providing investment banking, M&A advisory, capital raising, and strategic advisory services—we shape systems, processes, and transactions to support a sustainable, responsible future for cannabis.

MAZAKALI

Based in San Francisco with offices in Denver and Chicago, MAZAKALI offers capital placement services to family offices, accredited investors, RIAs and institutions via its Outsourced Cannabis Investment Officer (OCIO) service. MAZAKALI was founded to counteract the negative consequences of business practices that deplete resources by making investments in sustainable cannabis and hemp. By shepherding capital in a responsible and ethical manner, MAZAKALI and its clients envision a world where cannabis investment will play a significant role *Beyond Impact*. The MAZAKALI GreenPaper™ has gained authority through knowledge on deep trends in the industry that matter to investors and operators alike.

Fox Rothschild

Fox Rothschild is a 950-lawyer national law firm with 27 offices around the country. We have assembled a national team of skilled and experienced attorneys to assist cannabis businesses at every step, including banking, entity formation and venture capital. Cannabis growers, distributers, processors, investors and others turn to Fox for practical and efficient advice on regulatory and tax issues, mergers and acquisitions, real estate, intellectual property and employment law.

Poseidon Asset Management

Poseidon Asset Management is a 100% cannabis-focused investment firm founded in 2013. Having invested in over 50 companies, the firm is a known resource for founders seeking an investment partner who can add value by building out company synergies. Poseidon manages over $125 million and specializes in infrastructure, technology, agtech, industrial hemp, vertically integrated operators, and brands. Their current fund is open to new investors.

PitchBook

PitchBook Data is a Seattle-based private market research firm. Acquired by Morningstar in 2016, PitchBook covers an extensive swath of the private markets, including private equity, venture capital and M&A trends.

Introduction

If "innovation comes from the fringe," as Marc Andreessen has explained, there's no shortage of transformational opportunities across the emerging global cannabis landscape. Often we see that private market trends define a new market's trajectory. The cannabis industry is no exception to this rule and just might be rewriting the rubrics of impact as defined by other sectors.

In recent years, there has been a groundswell of research, with much of it dedicated to policy information, regulatory updates, public sentiment and estimates of the size and direction of the emerging market. Yet relatively little research has immediate, insightful and practical applications for the entrepreneurs, operators and investors working to build the cannabis industry from the ground up.

The inaugural MGO | ELLO Cannabis Private Investment Review seeks to address this information gap with the first published analysis dedicated to cannabis investments in the private markets. Powered by PitchBook Data, this report examines this generation's most dynamic industry from a private market perspective, investigating trends within venture capital (VC) and private equity (PE), as well as the first wave of consolidating mergers and acquisitions (M&A) that are reshaping the cannabis landscape.

As the cannabis industry evolves and matures, it is critical that entrepreneurs, investors, operators, policymakers, regulators and service providers all play a role in shaping and implementing legal, operational and financial best practices to ensure a sustainable and prosperous future for this industry. The MGO | ELLO Alliance is proud to support this process alongside our clients and partners. Frictionless access to accurate and reliable market and transaction data is essential to our mission of supporting a responsible and sustainable future for cannabis. We are honored to collaborate with PitchBook—the leader in public and private venture data and analysis—in creating this first-of-its-kind industry report.

We set out to shine a spotlight on the most pressing investment issues and trends facing the industry today. Our hope is that this report is informative to industry stakeholders themselves—the originators, innovators, operators and aggregators turning cannabis into a modern-day professional and, ultimately, socially beneficial industry. We also want to provide focused insight on market trends to help investors, companies, institutions and investment banks navigate risk in today's fast-moving market.

A special thank you is owed to our fellow sponsors—Poseidon Asset Management, Fox Rothschild, and MAZAKALI—who each work diligently to offer their own beneficial contributions to this emerging industry and who generously provided insight and analysis throughout this report.

Cannabis is one of the most promising and complex plants, and now industries, emerging today—with the potential to impact and reshape the global, social and business landscape. It has few, if any, predecessors, and its growth as an industry will be due to the efforts and risks taken by its past, current and future leaders. We hope this report acts as a valuable resource supporting sustainable growth now and in the years ahead.

Evan Eneman
CEO, MGO | ELLO Alliance

Scott Hammon
COO, MGO | ELLO Alliance

Where venture fits in

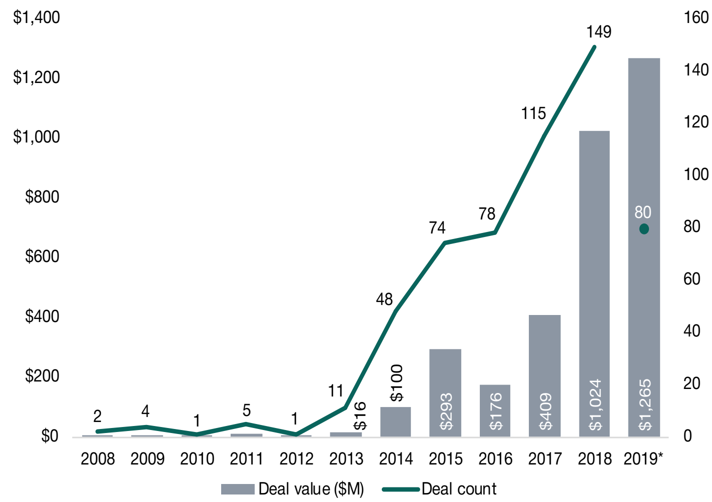
Investment in the cannabis industry has historically been fueled by angel investors, family and friends. Venture capital, despite its penchant for high-risk bets on high-growth companies, shied away from the industry due to its legal status. That began to change starting in 2012, when Colorado and Washington state both legalized adult use. Neither market was particularly big by venture standards, but investors believed that 2012 represented the beginning of a potential domino effect that would spread throughout the US over time.

Over the intervening years, that prediction has largely been borne out. Adult use is now fully legal in 10 states and in the District of Columbia. Medicinal use is now legal in 23 states, bringing the combined US cannabis market to 33 states. California, by far the largest market in the US, legalized adult use in 2016. Venture capital investment in cannabis startups went on to hit record highs in 2017, topping $400 million for the first time via 115 separate VC rounds.

Some of this influx can be credited to the California market, which is home to many venture capitalists, but momentum in the broader US market played a major role in the rapid increase in VC volume that year. By 2018, total value swelled above $1 billion, a milestone for the industry. The cannabis ecosystem matured relatively quickly: In 2013, just over $16 million of institutional capital was invested in the sector, and the $1.0 billion invested last year marked a 64-fold increase over the span of six years. Through mid-May of 2019, the industry has already set a new record in terms of value at $1.3 billion, with more than half a year to go. The only question this year is how high the final numbers will be.

As every industry matures, the amount of venture capital funneled into it increases almost exponentially. One significant reason is late-stage financings, which take time to appear. For the first few years of the industry's existence, VC rounds were limited to seed and Series A financings, which are smaller and far more speculative than late-stage growth rounds. As successful startups separate themselves from their peers, investors concentrate more capital into those companies to ensure their survival. Several cannabis startups have now crossed the Series C threshold—Eaze, Hound Labs and Canndescent, among others—which has historically symbolized long-term potential. Moreover, the industry is seeing its first billion-dollar valuations, including the recent $1.7 billion valuation given to Pax this past April. More unicorns are likely on the way over in the next two years.

VC cannabis deal activity

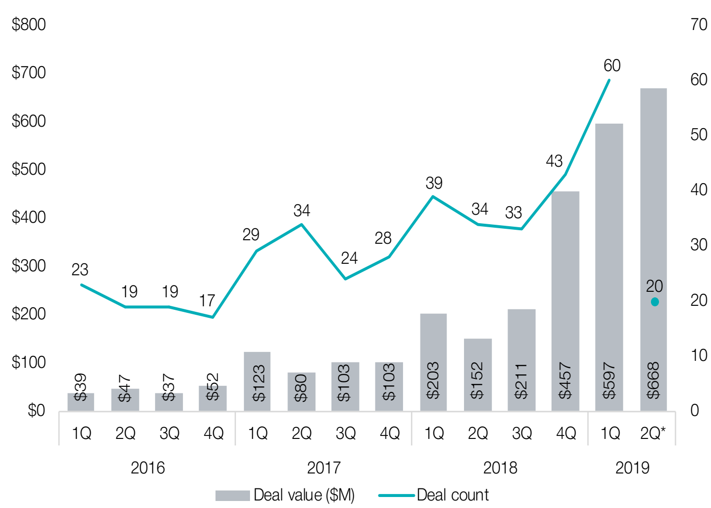


Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

"Capital flows are global at this point, as capex needs require billions of further deployment to support an industry expecting to head to hundreds of billions in revenue in the years to come. Not all capital will be treated well but the tailwinds are strong, even with institutional capital waiting on the sidelines for changes in US federal banking laws."

- Morgan Paxhia, Co-Founder, Poseidon Asset Management

VC cannabis deal activity by quarter



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*Data as of 5/15/2019

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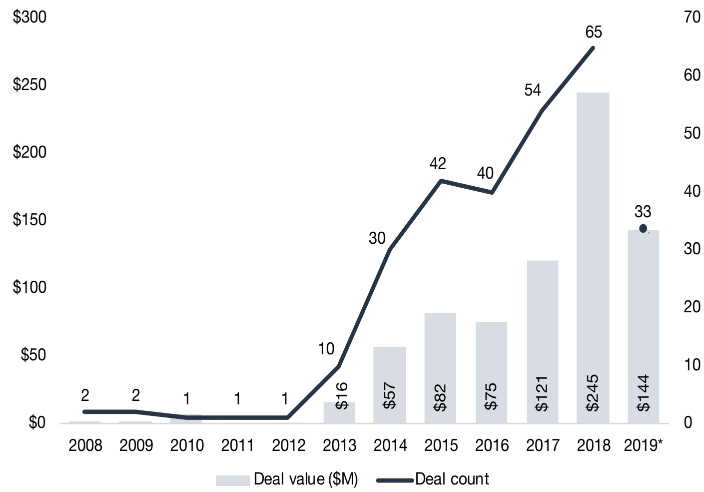
A growing ecosystem

One of the hallmarks of a startup ecosystem is the explosion of new companies formed in a short amount of time. One measurement for this is first financings, which are charted to the right. The first hints of growth were seen in 2013, just after Washington state and Colorado both legalized adult use. 10 venture financings were done the following year, although that figure only accounts for new companies securing institutional backing. The true number of cannabis startups was far bigger, but not every startup wants or seeks third-party capital. Moreover, there weren't as many cannabis-focused venture investors then as there are today. Supply and demand were limited in scope.

Both volume and value slowly began to grow over the following three years, with the next major boost in first financings (the first round of institutional capital that startups receive) occurring in 2017. That reflects the passage of legislation in California, which quickly turned into an attractive market for private capital. The consequences of California's legal change would be felt for the next two years, with 2018 seeing the first true explosion in first financings. 65 of them happened last year for a combined $245 million. This year is well on its way to surpassing both numbers, and the $144 million accumulated is already the second-highest figure ever recorded. It's worth noting the sudden upswing in value, which doesn't solely reflect the number of first financings made. Implicit in that figure is a more mature market, more sophisticated investors and startups and a much larger market in which to participate. Like the gradual increase in cell phone users, the increase in cannabis consumers and patients has a trickle-down effect for the potential scales of the companies that will cater to them. It's much easier to raise larger initial rounds today than it was six years ago. Startups can confidently assume they will need more capital to catch up to an ever-growing market. Venture investors recognize that and are willing to cut larger checks as a result.

As any industry matures, there's a natural transition in terms of early- and late-stage financings. Any new market can expect to see far more early-stage rounds compared to late-stage activity, as well as more dollars at the early stage. Cannabis has been no exception, and until last year, early-stage value remained higher than late-stage value. This year, however, will likely see the first reversal for the industry. Just over $660 million was invested in late-stage rounds through mid-May compared to almost $530 million at the early stage. Note also the imbalance between volume and value. The $660 million of late-stage

VC first-financing activity in cannabis



Source: PitchBook | **Region:** US & Canada
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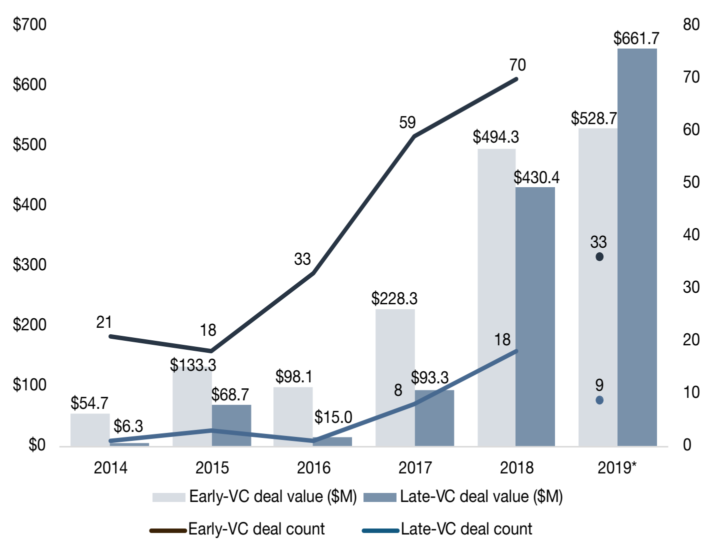
"With increasing legalization of cannabis use for both adult-use and medicinal purposes at the state level, new participants are entering the industry at a record pace, creating a significant number of opportunities for early-stage investment."

- Jacqueline Bennett, Director, ELLO

VC cannabis deal activity by stage



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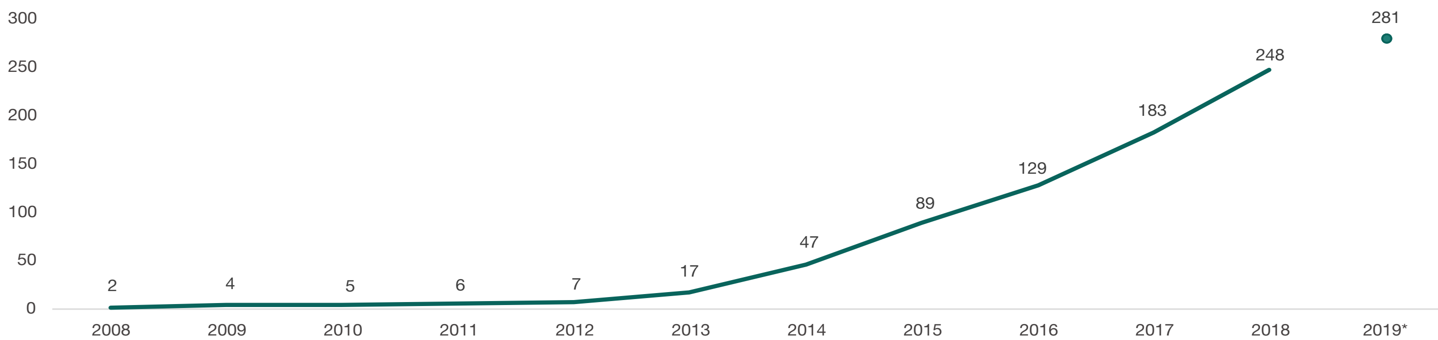
VC-backed cannabis companies (#, cumulative over time)



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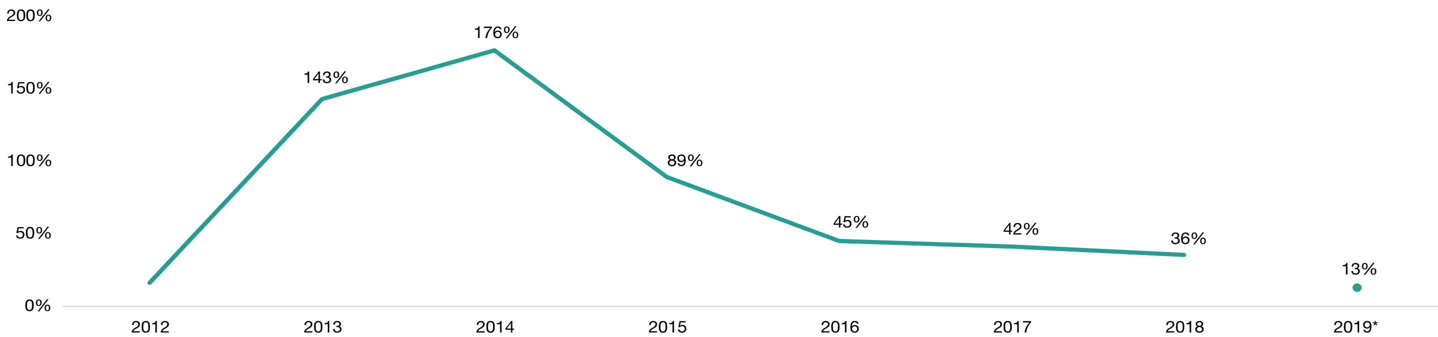
VC-backed cannabis companies (#, YoY percentage increase)



Source: PitchBook | **Region:** US & Canada
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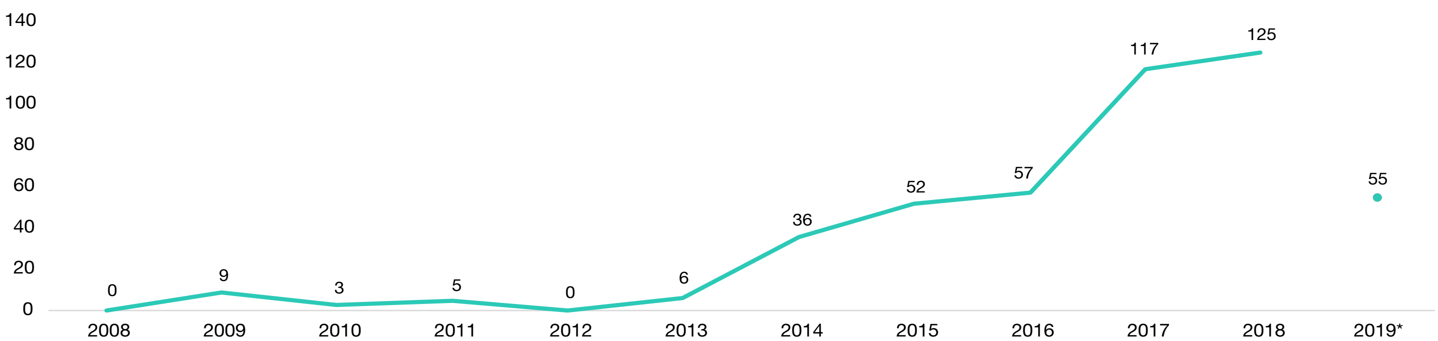
Active, unique VC investors (#) in cannabis



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rounds were done through just nine rounds, including $420 million for Pax's Series C alone. The $530 million at the early stage was spread between 33 financings. But because cannabis investing is still relatively young from a VC perspective, activity at all stages is expected to grow much higher over the next three to five years. There will simply be more companies at both ends of the spectrum to finance, and the market itself will continue to grow past its current boundaries.

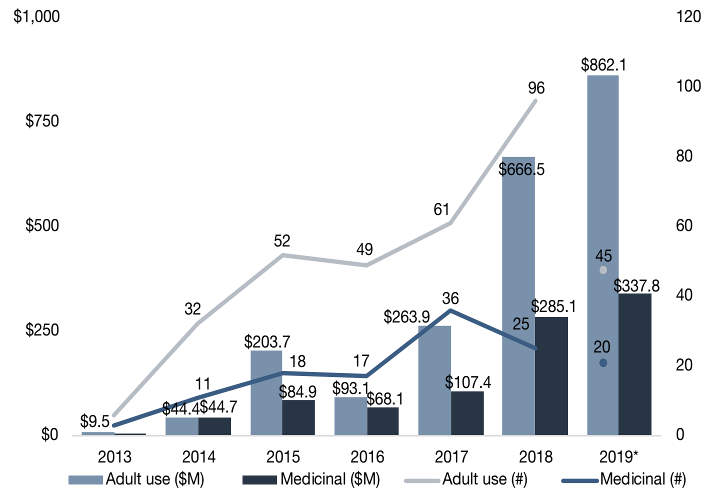
Location, location, location

Despite the maturity of the medicinal cannabis market, states that have legalized adult use are seeing significantly higher attention from VC investors. The potential market size for adult use is much bigger. At the state level, medicinal use is allowed in far more states than adult use is, though many of those markets are relatively small. From an investor's standpoint, the medicinal market remains attractive—both margins and profits are higher than compared to adult use. Even as states with adult-use laws have outpaced medicinal-only states, the latter has enjoyed a steady increase in VC dollar amounts. Startups in medicinal-only states (many of which are geographically distant from the investors themselves) have taken in at least $100 million combined each year since 2016. As is the case with many other statistics, 2019 totals are already a record. Almost $340 million has been funneled into medicinal-only states through mid-May, a few notches above last year's $285 million. We expect that market to eclipse $500 million for the first time relatively quickly. Adult-use states are already nearing $1 billion in combined value this year. The only question is how high that total will ultimately be.

The discrepancy between the United States and Canada is even starker. The US market is currently preferred by investors, despite its legal status. The Canadian startup market will trend higher following its federal legalization in late 2018, but it will still be dwarfed by its neighbor.

The $955 million that was invested was more than double 2017's output ($371 million). Volume has increased more gradually; it took two years for deal counts to double (from 2016 to 2018) while combined value achieved the same in only one year. That again reflects a growing number of late-stage startups that require bigger dollops of capital to expand. Canada boasts the largest cannabis companies by size, but they are all publicly traded, and many are conglomerates. Moreover, those public Canadian companies have enjoyed a steady ride of investor enthusiasm, which has pushed share prices to lofty levels. US startups are largely limited to the dynamics of the private market, where fundraises are fewer in volume.

VC cannabis deal activity by state law

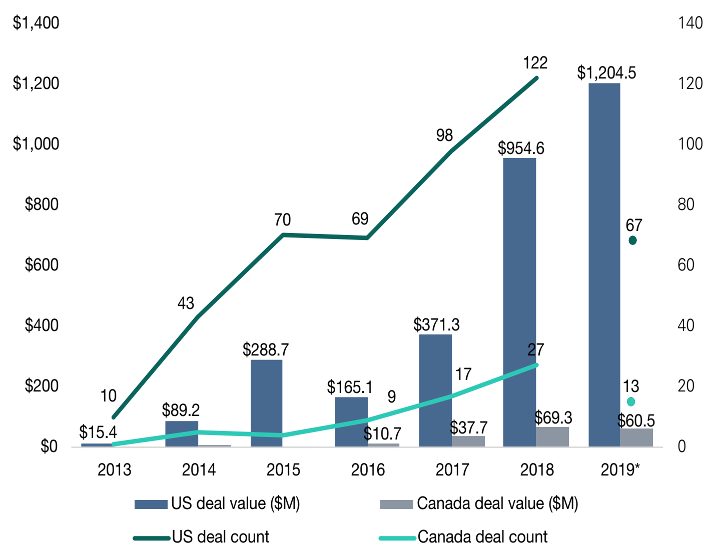


Source: PitchBook | **Region:** US
*Data as of 5/15/2019

"When states move toward legalizing cannabis for adult use, the result is an immediate expansion in the total addressable market. Companies with operations in these states benefit from premium valuations compared to peers operating in medicinal-only markets."

- Jacqueline Bennett, Director, ELLO

VC cannabis deal activity by region



Source: PitchBook | **Region:** US & Canada
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How do you value cannabis startups?

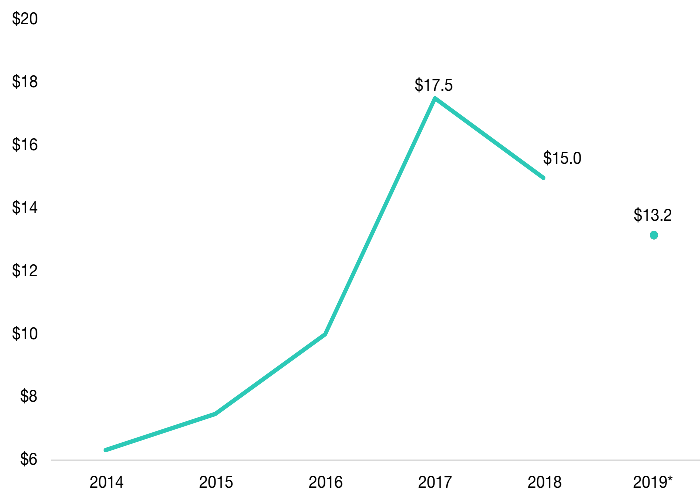
Both valuations and round sizes are trending higher across the cannabis industry. That's to be expected for any new industry, and cannabis is no exception. However, valuations in this industry have no true historical counterpart. Price tags are contingent on a wide variety of factors, including state-by-state regulations and market sizes. Another basic variable is whether a particular startup "touches" the plant or not. For those that do—at the cultivation, manufacturing, distribution and retail stages—myriad licenses are required to do business. That makes expansion more time-consuming and often cost-prohibitive, which will impact a startup's growth projections and ultimate valuation. Another important variable, given the difficulty in expanding to each legal state, is a company's market reach within the state where it operates. Valuations will naturally be higher in California than they will be in Oregon, regardless of how efficiently the company operates. Companies in smaller states often face pressure to expand.

The ancillary market is much easier to value, though its lack of highly valued licenses often means ancillary companies have lower valuations relative to plant-touching companies. Ancillary companies comprise startups that don't physically handle the plant at any stage. Examples include software platforms, media companies, consulting firms and online marketplaces. Ancillary companies can more easily expand across state lines because fewer regulations apply to them, which also removes the possibility of penalties that can temporarily halt business, as is often the case for their plant-touching counterparts.

The software vertical provides an example of this. There are simply more comparables for cannabis-related software companies, because their platforms can more closely mimic platforms in different industries. In addition, software companies can attract executive teams from a variety of other industries; less cannabis experience is needed on the ancillary side, which widens the talent pool. Capable managers are priorities for VC investors, who are known to grant higher valuations for startups that boast that advantage.

Despite the legalization problem, valuations and round sizes continue to go up and to the right. The average cannabis valuation in 2019 (so far) is $226 million, which blends both early- and late-stage. On a median basis, cannabis valuations have been above $10 million each of the past four years. Taken together, those figures reflect a growing number of late-stage valuations that are as high as they've ever been, while the consistent median reflects an expanding pool of early, low-valued startups just entering the market.

Median valuations ($M) for VC cannabis companies



Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

"We see a wide range of valuations in our industry with many factors to consider. Generally, we see expanding valuations primarily driven by crowding into well-socialized deals. The median valuation shows there is much more beneath the surface versus what is widely talked about in the media."

- Morgan Paxhia, Co-Founder, Poseidon Asset Management

Most companies are being valued based on revenue multiples, which vary by state and vertical, as compared to traditional industries where companies are usually valued on EBITDA multiples. The cannabis industry is seeing a gradual shift toward EBITDA, but much of the attention remains on revenue and top-line growth. Valuations are also impacted by supply and demand issues in the form of licenses. Where licenses are harder to acquire—on much of the East Coast, for example—companies that have those licenses will generate higher valuations compared to companies in places such as Oregon, where licenses are much easier to acquire.

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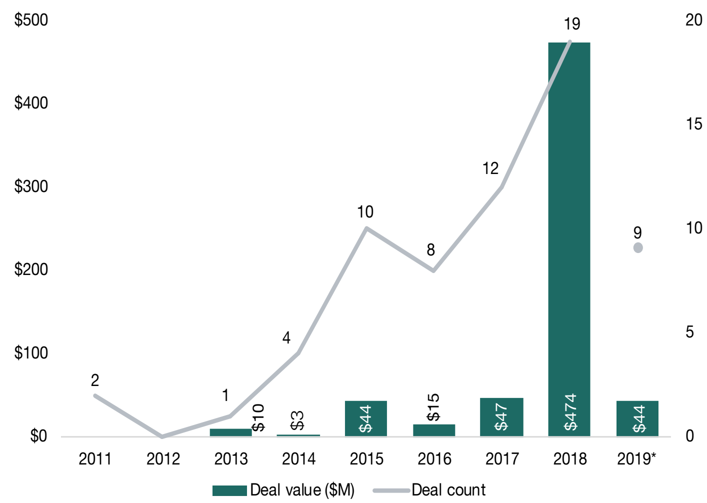
Is there a buyout market for cannabis?

Buyout volume in cannabis remains muted relative to VC activity. Investors have reason to be hesitant to take controlling interests in this market, despite its emphasis on strong cash flows. The buyout model relies heavily on predictability, and PE investors have historically been wary to buy companies that face threats from federal authorities. The VC model, by contrast, bakes in certain assumptions around portfolio company failures, and the biggest winners in a fund are often capable of returning the entire fund amount back to its limited partners. Most buyout funds can't survive many bankruptcies within a single portfolio.

Even so, the same industry hype applies equally to the private equity side, particularly for growth (or minority) investments. Cannabis represents a high-growth opportunity even in its current state, and federal legalization would open the floodgates to more control investments going forward. Last year saw a record 19 PE transactions valued at a combined $474 million. This year's volume is on pace to surpass last year's mark, with nine transactions through five months already. As more companies mature through the venture side of the market, PE/growth opportunities will pop up as more companies come to market. A proxy for this can be seen in late-stage VC activity, which takes similar form to PE/growth investments. As mentioned, late-stage value is already at a record high, and many of those companies will seek private equity dollars in the years ahead. There is reason to believe that minority transactions will continue to outpace majority stakes, however, at least until federal legalization.

As ELLO's Evan Eneman notes, there are signs of activity for "certain segments of the market by more traditional roll-up strategies" for sectors such as retail, lab testing and manufacturing. "These are trends that indicate that investors who are comfortable in certain segments will gravitate to those areas" where plenty of value creation is possible. A legal, national US market would add more potential customers across all sub-segments of the industry.

PE cannabis deal activity

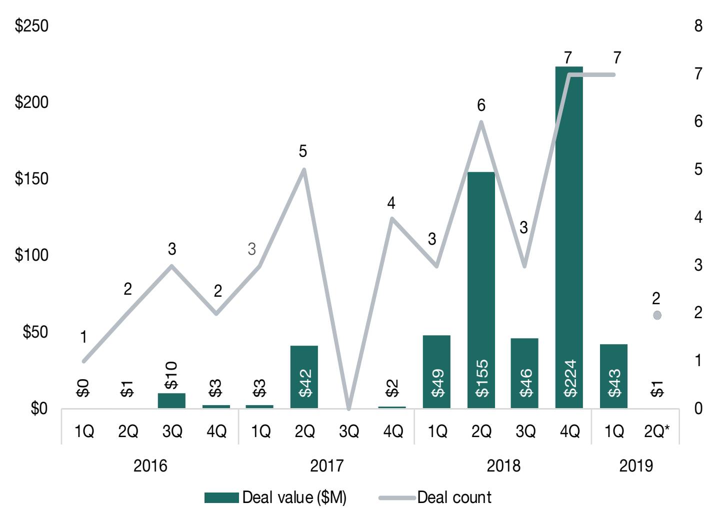


Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

"As the cannabis industry continues its growth, demonstrates stability, and those hurdles are overcome, we will be seeing more and more interest from the broader investment community, including private equity."

- Scott Hammon, COO, MGO | ELLO Alliance

PE cannabis deal activity by quarter



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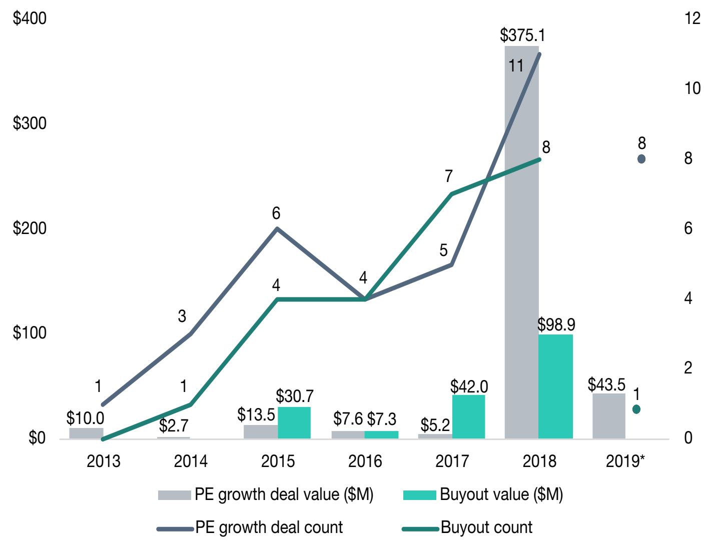
*Data as of 5/15/2019

The United States, again, represents a more fertile investment market compared to Canada. Of last year's $474 million in combined value, $375 million of that was earmarked in US-headquartered companies. While volume has been consistent between the two countries, US value began to significantly outpace Canadian value last year. Much of that discrepancy is due to one US market in particular: California. The California market is bigger than most other markets combined. Moreover, as many have remarked, California is quickly becoming the epicenter for the cannabis industry, not only in terms of cultivation and retail but in ancillary industries as well.

Software, for example, is a familiar sector to PE firms, and an attractive one at that. Software companies thrive off of recurring revenues and longstanding customer relationships. PE investors who are well versed in growing software companies can apply many of the same lessons from other markets into the cannabis sector since the underlying business model is largely the same.

An element working in favor of private equity is the opportunity for synergies within portfolios. Private equity firms are known to take advantage of licensing and other business opportunities within their own funds. The cannabis industry is quickly consolidating. That bodes well for the PE model, which is focused most on efficiencies and stable management. As cannabis companies mature, more experienced leadership will be called for in many situations. PE firms, especially those that operate in other industries, have extensive networks from which to pull new management teams. Because much of the cannabis industry overlaps with other industry models—software, advertising and consumer products, among others—PE firms that are familiar with ancillary industries will have an easier time poaching talent from other sectors to this high-growth market.

PE cannabis deal activity by type



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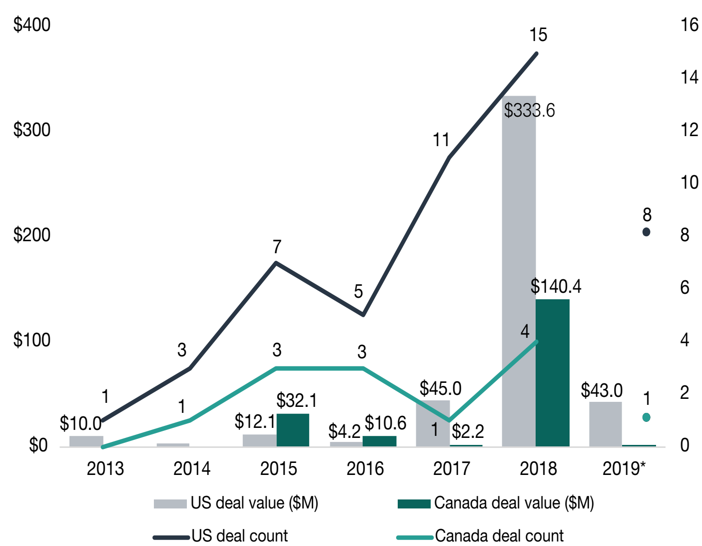
PE cannabis deal activity by region



Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

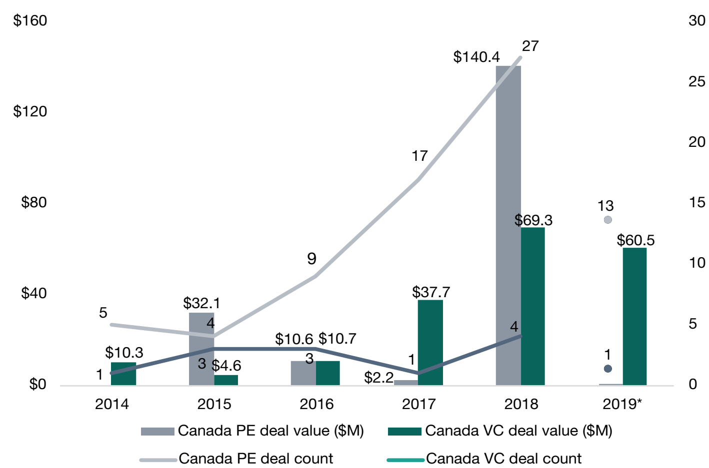
Spotlight on Canada

The Canadian cannabis market is an influential hotspot of the broader cannabis industry. While private market investment activity has been dwarfed by US activity in recent years, public Canadian companies still largely dictate the direction of the industry as a whole. Tilray, one of the world's largest cannabis producers, has recently traded around 300 times revenue. Whether that's sustainable is one question, but the hype around its prospects is validating assumptions for downstream markets. Because share prices provide a more current barometer of market sentiment than private market valuations, it's worth paying attention to Canadian stock prices as a broad, if imperfect, measurement of cannabis investor sentiment.

That said, it's worth noting how much more private financing is concentrated in the United States compared to Canada. Because Canada is one of the few markets where cannabis companies can list publicly, far more attention is paid to its public market than its private sector. VC investment in Canadian cannabis companies has yet to breach $100 million in a single year, whereas the US VC market has already eclipsed $1 billion five months into 2019. The same dynamic is true on the private equity side as well, where combined Canadian investment value was less than half of the US' value in 2018. The geographic comparison may change to some extent thanks to Canada's legalization of adult-use cannabis in 2018. The entire country is now open for business, which should spur more startup activity in certain provinces. Investors will pay attention to how much the market grows in reaction to federal legalization, as it may provide clues into the impact of US legalization in terms of private investment.

For years, US-based cannabis companies have gone public in the Canadian markets. Among other reasons, the CSE is welcoming to them and currently provides better valuations than the US markets available to them, according to MGO's Scott Hammon. Moreover, the Canadian investment community is hospitable to cannabis companies and requires less stringent reporting obligations for small-cap and early-stage companies. Canadian public markets should continue to be an attractive option for VC-backed cannabis companies going forward.

Private market cannabis deal activity



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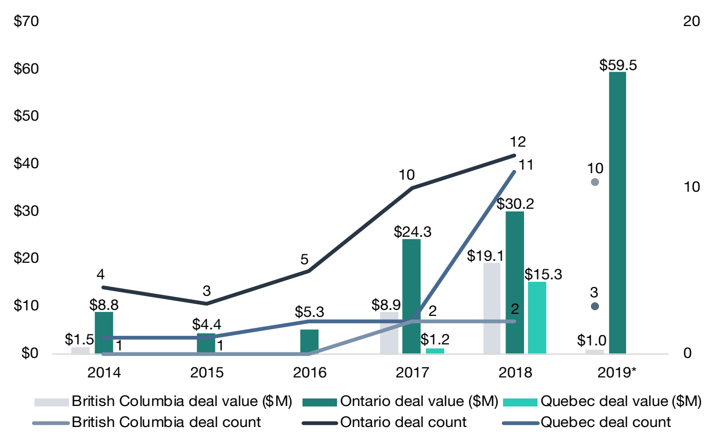
Private market cannabis deal activity by province



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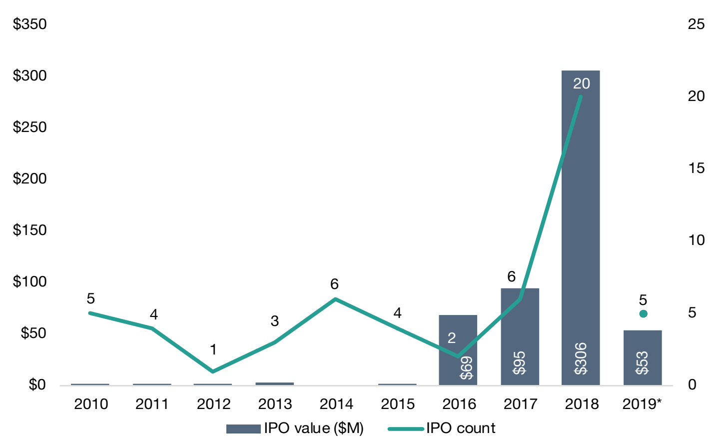
Cannabis IPO activity



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"The potential is colossal"

MGO | ELLO's Evan Eneman and Scott Hammon

You've written that you believe "2019 is shaping up to be a bellwether, illustrating that the cannabis industry is preparing for a growth explosion." What can we expect to see this year following a historic 2018?

SH: So far in 2019, the cannabis industry has predictably continued picking up momentum with record-setting capital raises and M&A deals. The only obstacle to this trend continuing would be interference at the federal level, but all indications point to progress and not back-sliding. The STATES Act and SAFE Banking Act are earning unprecedented bi-partisan support. If these acts, or any variation of them, pass in the coming months we are likely to see even more growth. An emerging trend in 2019, has been the use of options to lock in a US acquisition at a later date and contingent upon federal legality, or in an individual state when non-resident or corporate ownership is allowed. We've also seen the scope of M&A expand to a larger geographic footprint as more markets emerge and multi-state operators step up to serve a broader consumer base.

Please share your thoughts on consolidation trends within the medicinal cannabis industry compared to the adult-use side. Are the two markets following similar trajectories?

EE: The differences between the markets are quite interesting. While the adult-use market is broader and some see it as having more long-term growth potential, the medicinal-use market has a number of appealing characteristics. Firstly, public opinion in the US is overwhelmingly in favor of medical cannabis, and there are ample models of successful regulatory programs. Additionally, the progress of medical cannabis at the pharmacological level is very intriguing. Just last year, the FDA approved the first CBD-based medicine, clearing the path for further descheduling of cannabis compounds. Pharma is an entrenched, multi-billion-dollar global industry, and if cannabis is fully embraced by the medical/pharma sector, there is vast and lasting growth potential. There is also an even wider path for growth in the health & wellness category, where cannabis compounds have already had a significant impact.

On the other side, the potential of the adult-use market is colossal. If federal legalization does occur, a couple years down the road cannabis products are likely to be household items. Currently, public support for adult-use cannabis is trending upwards, but there are greater roadblocks and difficulties on the path to full legalization. While the adult-use market may have more short-term growth potential, investors recognize there are also greater risks.

Household names like Coca-Cola and Anheuser Busch are looking to get into the industry in various forms. What impact do those movements have on the market from a private investor's standpoint?

SH: When major consumer brands make headlines investing in cannabis, or publicly consider investing, it reinforces the legitimacy and inevitability of the cannabis industry. Political winds shift, and public opinion can rise and fall, but when multi-billion-dollar multi-national enterprises make the decision to explore investing in the cannabis space, it validates the industry. This communicates confidence to the entire industry and provides a lift to the valuations of both individual companies and the industry as a whole.

EE: As far as the effect on investors, major brands bring levels of capital to the table that dwarf many traditional paths to raising capital. As we've seen with Constellation Brands and Altria, their sizable investments have the potential to reshape the industry. And as comparable company valuations rise, it absolutely has an effect on fueling ever-larger exit assumptions. The other benefit of market validation is the impact on specific product and category segment validation. Some investors prefer to focus in core areas, like food & beverage, and this

Evan Eneman
CEO, MGO | ELLO Alliance

Evan has more than 18 years of experience assisting private and public companies in cannabis, financial services, healthcare, technology, media and entertainment. His areas of expertise include: investment banking, raising capital, strategic M&A, and financial advisory. Evan is also the founder and Managing Partner of Sands Lane Capital, and the founder and CEO of cannabis branding and marketing agency Fiorello.

Scott Hammon
COO, MGO | ELLO Alliance

Scott has over 30 years of experience assisting public and private companies in a variety of industries, including cannabis, technology, CPG and retail. He focuses on working with growth companies, having taken multiple such companies from the development stage through a sale, IPO or RTO, on both domestic and international securities exchanges.

> If federal legalization does occur, a couple years down the road cannabis products are likely to be household items.

gives those investors a pathway to both understand and invest in the market, as well as know there is some potential to exit on the horizon.

As more cannabis startups gain market share and become profitable, do you expect to see an increase in PE buyout activity?

SH: As the cannabis industry gains momentum and normalizes, we will certainly see an increase in private equity buyouts and further consolidation throughout the industry. One of the factors driving M&A and investment activity is the race to acquire licenses. For funds with capital ready to make a move, significant opportunities exist to build and scale an industry leader through consolidation.

EE: Depending how one defines "generalist" a number have already had an impact, and it is only a matter of time before even more enter the space. One of our core tenets is working to ease the path for institutional investors to enter cannabis. There are still a number of roadblocks and concerns swirling around the cannabis industry, which has kept many risk-averse investors away. We're also seeing focus on certain segments of the market by more traditional roll-up strategies. For example, pure-play retail, or analytical lab testing or manufacturing; these are trends indicating that investors who are comfortable in certain segments will gravitate to those areas and there is plenty of value to be created. As the cannabis industry continues its growth, demonstrates stability, and those hurdles are overcome, we will be seeing more and more interest from the broader investment community.

How are investors navigating valuations for companies that have gained market traction but still operate in an industry with so many hurdles?

EE: Valuing a business in cannabis is equal parts art and science. Assessing the value of high-growth businesses in any industry is a difficult undertaking, only magnified in cannabis due to the industry's nascent stage, regulatory risks, and lack of traditional valuation metrics. Ultimately, investors are likely to rely on the guidance of advisors who have deep industry experience and understand cannabis companies, and the deals that make industry leaders, inside and out. Market comps are a good barometer to start, but there is much more that an investor needs to consider within the company, including their growth strategy and pathway. We have helped our clients and investors cut through some of the market hype to see and unlock underlying value.

Do more comparables make valuations any less complicated, or do differing state and local regulations negate that benefit?

EE: The growing number of comparables certainly helps in valuing cannabis businesses, but given the impact of state and local regulations and licensing policies on valuations, the benefit of additional comparables is limited, as true comparables need to reflect that geographic impact. The industry is growing so quickly and changing on a daily basis, so we have a long way to go before the cannabis market settles down and valuations get easier. It also complicates certain aspects as operators, and in some cases investors, want to leverage a comp but don't take into account the full picture. Factors such as operating in different regulatory environments, geographies that have different dynamics, and other aspects that actually do not make them good comps, with the exception of the "category" they're classified in.

Switching gears, what expectations do you have for Canadian IPOs over the near term, with so many US-based companies raising significant amounts of private capital over the last 2-3 years?

SH: We don't expect Canadian cannabis IPOs to slow down in the near term. In the last year, MGO has been proud to work on several of the largest go-public transactions for US companies in Canada. While private capital is active, the benefits of going public, and potential capital raised, greatly exceed what is available privately. We expect a steady stream of industry leaders to continue to go public in Canada for the foreseeable future, especially since there are likely to be opportunities to dual-list or switch exchanges and access greater share liquidity.

EE: I take a slightly different approach on this. I do expect some slowdown in companies planning to go public in Canada and deciding instead to wait and see what happens in the US market within the next year. If there's a pathway, many would rather leverage US markets and liquidity. If there's an immediate capital need or constraint or a clear strategic reason to be a public company, then I would agree with Scott on how the Canadian market offers a very viable and potentially valuable opportunity for US companies.

Where do you see the cannabis industry 10 years from now?

SH: We expect to see continued differentiation and specialization as the industry segments into pharma, health & wellness, beverages, CPG and similar groupings. In the next few years we expect sensible regulatory frameworks to take hold and issues like 280E and banking access to be resolved, which will assist and accelerate the segmentation.

EE: I echo these sentiments from Scott. More specifically, I expect to see the industry and its myriad touchpoints throughout everyday life. We will also have the benefit of well-conceived and structured research that will help us understand the benefits and boundaries the plant and its compounds offer.

Fox Rothschild LLP
ATTORNEYS AT LAW

"It's only a matter of time"

Fox Rothschild's Josh Horn and Matt Kittay

Joshua Horn

Partner, Co-Chair of Cannabis Law Practice

Joshua Horn is a Partner and Co-Chair of the Cannabis Law Practice at Fox Rothschild. Nationally ranked by Chambers USA as a leading Cannabis lawyer, Josh is a member of the National Cannabis Bar Association and serves on the Editorial Board of the Cannabis Law Journal.

Matthew R. Kittay

Partner, Co-Chair of M&A

Matthew R. Kittay of Fox Rothschild is nationally ranked by Chambers USA as a leading corporate attorney in Cannabis Law. A Partner in the firm's New York office, he is Co-Chair of the Mergers & Acquisitions Group and Chair of the New York Corporate team.

What are the most common legal questions posed to early-stage startups?

JH: There are two issues that come to mind. One: What's going to be your corporate structure? And that ties in to the second question: How and where do you apply to get a license? They're tied together because you have this federal-state dichotomy, where clients create holding companies with separate standalone companies that are in particular states where they want to get a license. From an asset protection standpoint, you want to keep the businesses separate, so if there's a problem in one state it doesn't affect the entire corporate structure.

This seems like a high-growth industry just from a legal perspective.

JH: We formally launched the practice at our firm just a few years ago. And in the course of just a single year, the revenue we generated from servicing clients in this area nearly quadrupled. We anticipate a continued upward trajectory as the industry continues to grow and more and more companies seek out experienced legal counsel on the myriad of regulatory, funding and other issues. Our practice has grown so substantially, in fact, that representing cannabis industry clients now encompasses the bulk of my work. Cowen and Company projects this industry will become a $75 billion business over the next 10-15 years. And Fox Rothschild will be growing right alongside the industry.

Let's say cannabis is federally legalized in the next 10 years. What happens to the industry's current incumbents?

MK: I'm reminded of a mural I saw at a Kentucky barbeque roadhouse. It had hundreds of soda bottle caps from the 1940s, 50s and 60s, and you would recognize fewer than 10% of them today. A lot were local root beers and cream sodas that I'm sure were all important regional brands at the time, and they probably consolidated with a major brand over the years. Another good analogy can be found in the tech industry: It's more like the AOL and MySpace era presently than the Facebook or Instagram era. I'd predict there's probably room for 10 dominant national brands in the cannabis industry. Whether any of those future dominant brands exist now is hard to say. The industry is still in a nascent stage, and there's much inefficiency in the market to address and remedy.

Do you get the sense that major brands are champing at the bit to get into the market?

JH: Absolutely. We had an overseas client who developed a new extraction device, which he was trying to get patented overseas. Major pharma is already approaching him to buy his technology. He was telling me anecdotally that pharmas were scrambling to get IP in this industry.

MK: The major investment banks are all evaluating the opportunity, but they have a sophisticated, conservative view of things. They see a market with little template for success, lots of opportunity for failure, unknown regulatory risks and inefficiency in the banking system. They're waiting to be able to fit the cannabis industry into their more rigid models. There needs to be more data, more sophisticated case studies.

We work with many of the companies that make up this report's datasets. We handled many of those deals, but we had to reinvent the wheel for each one because they all started from foundations they cobbled together as the various state markets emerged. There weren't blueprints to build upon, and the rules changed beneath them, which relates to my prior point regarding general inefficiency. That's why I don't see a change in regulatory structure as the tipping point for major banks or companies to flood into the industry. A regulatory change would result in more deals, which would give the biggest players more datapoints to use as a model. There would be first-movers in that scenario, and they might get the best deals at the best valuations along with first-to-market advantage, but they might take it on the chin.

Where do you see the cannabis industry 10 years from now?

MK: I see New York becoming a peak market, and I think there will be more anchor points in places like Florida, for example. I also think we'll see some brands emerge in a meaningful way nationally. We've already watched the shift from state to regional. Previously, everything was at the state level because it was beyond the wherewithal, legally and financially, to operate sophisticated businesses simultaneously in multiple states. Now you see companies operating on a consolidated level but on a regional basis. Going forward, I think we'll see companies not just in eight or 10 states but in 30 or 40 states. Additionally, I think companies will gravitate less toward the Canadian public markets, which is the best game in town at the moment. We'll see more unicorns and less pressure to head north of the border. It's been challenging for some companies because they never envisioned themselves being Canadian public companies, but that's been their best option.

Are some of them looking to get acquired?

MK: There are a lot of strategics seeking distressed assets right now—small groups of dispensaries in the $1-$5 million enterprise value range. Those owners would be thrilled to get $3 million, and the investors would be thrilled to roll them up for $3 million and grow them into something bigger. At the higher level are regional players, but no one above them can really acquire them, which again is why the public market is the only game in town currently. Some regional players are going to merge with other regional players so they can dominate certain markets. There aren't any Fortune 500 companies looking to gobble up these assets, but there is private money coming in above the $100 million range. So large investors, but no large buyers yet.

JH: You'll see regional consolidation, with companies trying to create a national footprint in anticipation of the big corporate buyers coming in. Presumably, if a company has operations on both coasts, they'll be more attractive to a mega merger when the time comes, and I do think it's only a matter of time.

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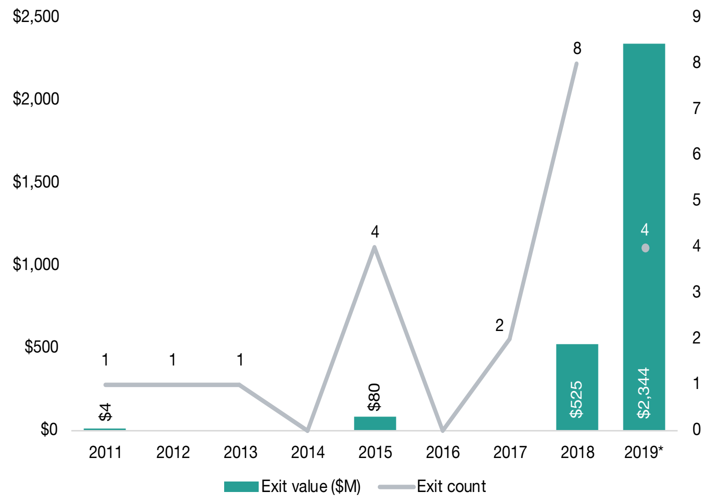
The exit question

The health of any private market depends, in large part, on strong and predictable exit ramps. Any investments made in private companies, whether young or established, will assume some sort of eventual exit in order to return money to investors. When new markets are established, whether they be in social media, artificial intelligence or any other sector, the "exit question" becomes a bit trickier because exit options aren't always obvious at the beginning. Cannabis, however, poses a separate problem entirely because of its legal status.

As is, cannabis startups have very few ways of exiting. As mentioned, one prominent option is the Canadian public market, which has been utilized by several US startups—many of which probably did not foresee becoming Canadian public companies when they began. The possibility of being acquired at some point is there for most startups, but the data suggests a disconnect between acquisitions of VC-backed cannabis companies and overall M&A trends. The latter figures are far larger, especially in the past five quarters, while VC-backed exits are relatively sparse. That poses a question when comparing investment and exit levels: How are investors gauging their chances of exiting before they decide to invest in cannabis companies?

Seasoned market observers suggest that exit opportunities will come as the largest cannabis companies consolidate regionally, boosting M&A numbers over time. In some cases, especially on the ancillary side, cannabis-related consulting and software companies may be acquired by strategics outside the cannabis space. Hound Labs is a prime example. The company develops and manufactures cannabis breathalyzer kits used by employers and law enforcement, and its chances of being acquired appear strong. Another household name in the industry, however, poses different questions. Pax, a vaping pen manufacturer recently valued at $1.7 billion, makes for an iffy acquisition candidate, despite its growth prospects. As cannabis companies grow in value—particularly companies that touch the plant—the more likely they are to become candidates to go public in Canada, barring any regulatory changes at the US federal level. If legalized across the US, the exit question will likely answer itself.

VC cannabis exit activity

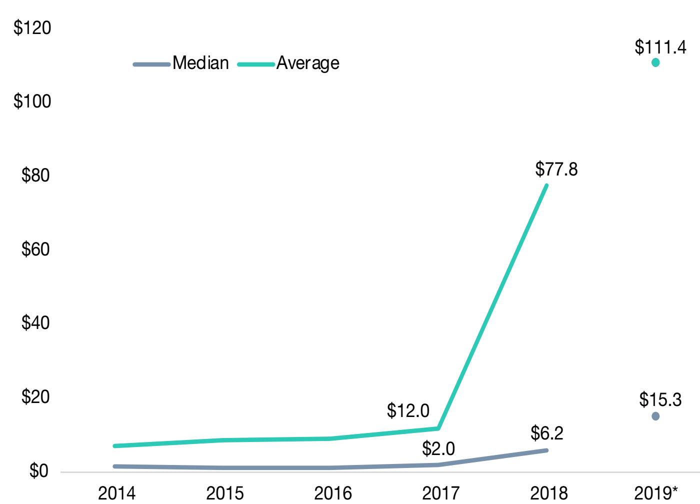


Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

"The current M&A market is largely centered around cannabis license acquisitions as operators seek to expand their footprints in as many states as possible. Many VCs are focused on other industry verticals—technology, brands, ancillary equipment—as it can be hard to achieve a 10x return through license consolidation. I expect VC-backed exits will grow quickly as the industry enters its next phase of growth."

- Dan Nicholls, Director, ELLO

Median and average cannabis M&A deal size



Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

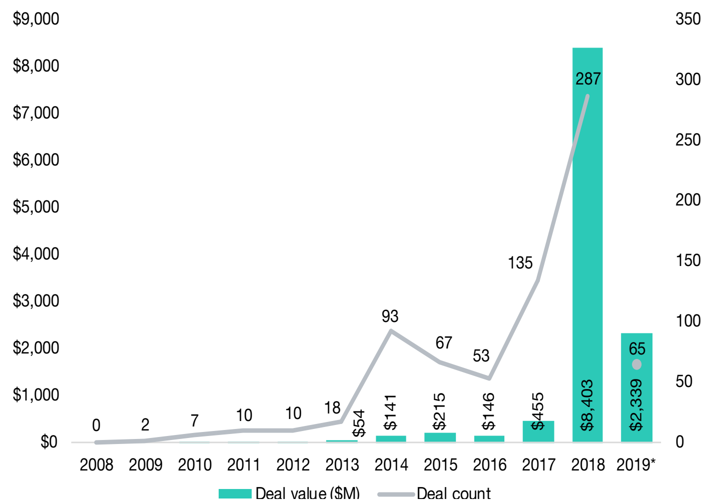
A large percentage of all cannabis M&A value is driven by large Canadian strategics. Much of the consolidation underway in the industry is happening in Canada, with targets consisting of both Canadian and US companies. That narrative is unlikely to change until the US legalizes cannabis use at the federal level.

That said, there is reason to believe that M&A activity will gain steam in the US in coming years. As mentioned, a handful of large, reputable consumer brands are testing the waters in the industry, including Altria, Coca-Cola and Anheuser-Busch. If current regulations are left in place, it's unlikely the market will see major M&A moves from reputable corporate brands, if only because any large transactions may be made null and void if the federal government comes down negatively on the legality question. Transactions that move the needle are made deliberately and with foresight, and few can be categorized as "bets" at the corporate level.

Where the market will see further consolidation, however, is at the regional level. Relatively established cannabis companies will look to acquire more capabilities and locations in an effort to dominate regional markets. Moreover, ambitious acquirers looking to establish national footprints will continue to scour for acquisition targets where cannabis use is now legal, on the medicinal side but especially in the adult-use market.

Market observers have predicted an M&A boom in the cannabis industry, and it appears major consolidation efforts are already well underway. Almost 300 strategic acquisitions were made last year valued at a combined $8.4 billion. Both marks were record highs by a large margin; 2017 levels look miniscule by comparison, though both volume and value that year were the largest recorded figures up until 2018. The market changed suddenly in 1Q 2018, when almost $1.4 billion worth of acquisitions were executed in a single quarter. For context, 1Q 2018 value more than doubled the total M&A value the cannabis industry had ever seen. Activity persisted throughout the year, peaking at $3.5 billion in value in the third quarter. By the end of the year, the cannabis space saw four consecutive quarters above $1 billion. The prior record on a quarterly basis was $338 million in 1Q 2017.

Cannabis M&A activity

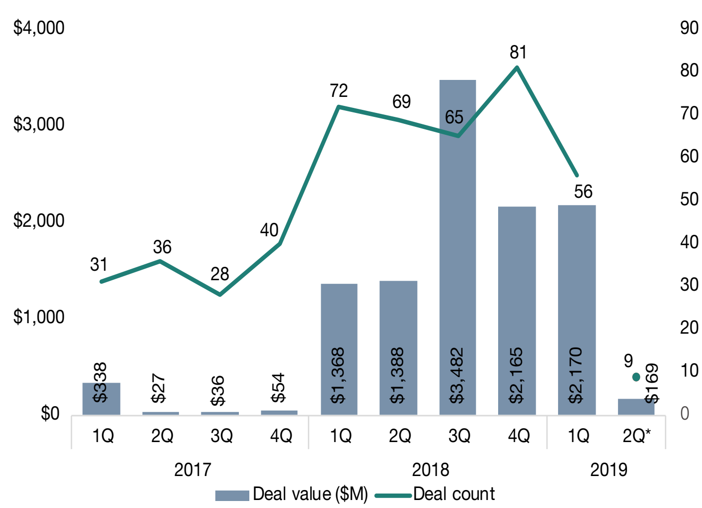


Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

"Expect a large wave of consolidation pre-legalization as companies band together for survival or acquisition and a larger wave post-legalization as those outcomes are realized."

- Sumit Mehta, CEO, MAZAKALI

Cannabis M&A activity by quarter



Source: PitchBook | **Region:** US & Canada
*Data as of 5/15/2019

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Educated Minds Make Educated Choices.
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"The asset class to watch"

MAZAKALI CEO Sumit Mehta

Private investment in the cannabis industry has grown significantly since adult use was first legalized in Colorado and Washington state. What broad investment trend lines can you share with us?

SM: The march towards federal legalization has been accompanied by capital inflows from increasingly sophisticated sources. An inevitability for this ancient herb is agricultural commoditization with implications for each component of the supply chain, along with their respective business ecosystems. Focus on this margin march is imperative in an environment in which relative information opacity dictates that interest and capital generally outpace knowledge. Access to capital, while difficult in any industry, has been more challenging in the cannabis industry for a myriad of reasons. Despite these challenges, cannabis capital infusions are at an all-time high and will likely not be this low for the next several years of industry growth.

The cannabis complex consists of the following broad sectors with varying legal status: Licensed, Ancillary, Hemp, Real Estate and International. While Real Estate and the Ancillary sectors have been traditional safe havens for cannabis investors, the reduction in stigma combined with the acceptance of legalization inevitability in recent years has driven increased investment in the Licensed space. Watch for investment growth in Hemp and International as investor interest continues its evolution.

Are we nearing a tipping point for federal legalization and what does that mean for existing cannabis businesses?

SM: We are past the tipping point and federal legalization is now an inevitability rather than a question. The road to maturity for any emerging market is paved with consolidation and the cannabis industry is no exception. Every current industry participant faces one of only three outcomes in a federally legal environment: survival, acquisition or dissolution.

We are seeing the beginnings of an M&A cycle as more companies begin to understand this inevitability and choose to strengthen in numbers. "Cultivation & Retail" has been the highest M&A sub-sector for the past three years as margins have become more normalized at both ends of the supply chain. Expect to see a meaningful pickup in M&A activity across many other cannabis sectors as this emerging market moves from fragmentation to oligopoly.

Cannabis will change our medicine, environment, social bond and collective perception, and society will successfully adapt and evolve to embrace these positive steps. Businesses that are creative, resourceful, flexible and persistent will survive impending consolidation. We are in the midst of a novel business renaissance in an industry building itself with relative lack of interference from corporate America.

Besides federal legalization, what do you see as the biggest potential headwinds for the industry going forward?

SM: As the industry matures, consolidation, subsequent economies of scale, and advances in technology will reduce the necessity and value of vertical integration except where protected by law. Expect a large wave of consolidation pre-legalization as companies band together for survival or acquisition and a larger wave post-legalization as those outcomes are realized.

Sumit Mehta
CEO, MAZAKALI

Sumit Mehta is the Founder and CEO of MAZAKALI, a cannabis investment firm based in San Francisco with offices in Denver and Chicago. MAZAKALI offers capital placement services to family offices, accredited investors, RIAs and Institutions via its Outsourced Cannabis Investment Officer (OCIO) service. Sumit serves on the Finance & Insurance Committee for the National Cannabis Industry Association and is a finance and strategy consultant to The Arcview Group, the largest cannabis focused private investor network in America. Prior to joining the cannabis industry, Sumit spent two decades on Wall Street at Merrill Lynch, UBS Investment Bank, Susquehanna International and Raymond James Financial. In 2016, Sumit left an advisory practice at J.P. Morgan to launch MAZAKALI. Sumit earned an MBA from the Ross School of Business at the University of Michigan, and a BA with Honors in Economics with minors in Math and Physics from the University of Texas at Austin. Sumit holds investment banking, brokerage and investment advisory securities licenses and resides in San Francisco where he enjoys motorcycles, yoga, craft beer and the great outdoors. www.mazakali.com

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The MAZAKALI GreenPaper™ remains an authoritative and concise report on deep trends in the industry.

Between March 11, 2000 and October 9, 2002, stocks lost $5 trillion in value while the NASDAQ dropped over 78%. Dot-com companies had maintained outsized spend on marketing to capture mindshare, a strategy that was forced

> It is likely that cannabis will prove to be the best-performing asset class over the next decade and it is unlikely that at the end of the decade one will be able to name an industry untouched by this plant.

to evolve into a focus on cash burn as venture capital dried up. Valuable lessons from this era can help address cannabis company myopia.

In addition to consolidation, the cannabis industry is also unusually impacted by legislation, taxation, trade barriers, regulation and margin normalization across every investable sector. Similarities to other sectors and cycles help shape the tools needed to address these navigational challenges.

Do you believe cannabis will remain a niche investment space within the private market? Do you see generalists getting into the space if market growth continues at this pace?

SM: It is likely that cannabis will prove to be the best-performing asset class over the next decade and it is unlikely that at the end of the decade one will be able to name an industry untouched by this plant. Meaningful institutional investment has been muted far more by the plant's federal status than by lack of interest. Expect to see investment floodgates open wide the day cannabis ceases to be a Schedule 1 controlled substance.

The long-held view that social and environmental issues are to be addressed by philanthropic donations while financial returns remain the exclusive driver of investment decisions is changing. A growing mindset that desires social impact alongside investment returns explains the growth of impact AUM over the past decade. Cannabis has immense potential for medicinal, agricultural, societal and environmental impact, and shifting attitudes towards this ancient herb lead it squarely towards the crosshairs of this investment style. While propaganda and prohibition have certainly influenced people's views on cannabis as a vice, rapidly shifting attitudes allow us to view this asset class in light of its societal impact on our plants, people and planet alongside profit.

What sectors of the cannabis industry are investors most excited about?

SM: Investment interest has continued to migrate from Canadian Licensed Producers to vertically integrated facilities to Multi-State Operators and now has Cannabidiol (CBD) in its cross-hairs. While scalable Ancillary businesses continue to receive investor attention, it is useful to note that cannabis is sold by strain while most products are sold by Brand. There is a large and lucrative opportunity to create national brands in many cannabis product categories and large investments in the same will precede consolidation.

> Cannabis exhibits high growth, high fragmentation and high attraction to new entrants.

Growth in shared-use facilities has led to manufacturing ecosystems that allow brands to launch without incurring often-costly licensing, equipment and real estate expenses. The cannabis industry exhibits high growth, high fragmentation and high attraction to new entrants. As such, we expect continued growth in local brands prior to eventual consolidation and market right-sizing. Manufacturing facilities with professional anchor tenants provide needed incubation environments for new entrants and may enjoy sustainable margins until mature oligopolistic balance replaces emerging market fragmentation.

Does today's young cannabis industry have any comparisons? For example, many compare the current AgTech market to the early pharmaceuticals industry in terms of early-stage risk, R&D requirements, sheer market size, etc. Do you see any historical counterparts for cannabis?

SM: While one can learn many lessons from other regulated industries including tobacco, alcohol and gambling, it is valuable to look at the last hyper-growth industry of the modern era–broadband adoption. The release of Windows 95 didn't only mark the arrival of the graphical user interface, it also spawned a five-year period in which companies saw an unprecedented boom in valuations, business opportunity and access to capital. A corporate name change to include '.com' meant cumulative abnormal positive returns without the expected post-announcement negative drift and over 100 public companies adopted this strategy in 1998-1999 alone.

Technology was then an industry and now one is stretched to think of any untouched by it. While the cannabis movement is quickly evolving into an industry, it is similarly difficult to imagine a single sector that will remain untouched by this plant in the decades ahead. 750 medical uses and 50,000 industrial uses remain but a surface indication of the deeper impact potential of this ancient herb. Cannabis will change our medicine, environment, social bond and collective perception, and society will successfully adapt and evolve to embrace these positive steps.

Where do things go from here?

Cowen and Company estimates that the global market will generate some $75 billion in annual spending by 2030, an increase of $25 billion over anticipated sales in aggregate for 2026. This rapid growth is already being fueled by the increasing number of jurisdictions that have enacted some form of adult-use legislation, removing prohibition in several parts of the US to give many of the roughly 21 million monthly adult-use users access to the full range of cannabis products from licensed retailers. Although Canada and California are projected to reach $5.9 billion and $5.6 billion, respectively, in spending by 2023, other states are set to increase sales from some $1.7 billion in 2014 to $16.6 billion in 2022 while the rest of the world adds another $3 billion to its $600 million in spending last year over that timeframe, according to BDS Analytics.

While many institutional investors remain wary of TTP companies, the market for ancillaries should draw even greater attention from strategics and financial sponsors interested in businesses that can more easily traffic across state, provincial and national boundaries. In addition, with greater regulatory certainty in place in the US, consolidation strategies predicated on private equity's buy-and-build strategy should lure firms off the sidelines and into the field. Buyout deal value in the US and Canada combined has already increased from just $7.3 million in 2016 to nearly $100 million last year. Platform creation via add-on deals also appears poised to grow as a result.

Should a clearer regulatory framework take shape in the US sooner rather than later, as many predict, the $1 billion in VC raised last year could quickly come to represent just a jumping-off point for funding figures going forward. Combined with market maturity, investor enthusiasm will inevitably produce leaders at different points in the value chain—all of which should encourage further institutionalization of private capital coming into the wider cannabis space. For the moment, though, the expansion of financing rounds for ancillaries at higher valuations would appear to be a somewhat reliable lagging indicator of private market sentiment. That advantage has been exaggerated by supply surpluses bringing wholesale cannabis prices down dramatically in established adult-use markets, pushing some licensed producers to explore higher-margin uses of cannabis to create products with longer shelf lives, such as edibles and vaping products, while still others look to embed hemp-derived CBD into beauty products and THC into foods.

As legislative measures in the US open new markets up to investors, companies receiving higher valuations will be characterized by a confluence of factors, including the ability to operate across state lines, lengthier tenures of operational experience among company leadership and tighter overlap with established verticals—particularly those in software. Meanwhile, with the passage of the Farm Bill late last year in the US, hemp-derived products appear poised to propel CBD and, by extension, THC-based products nearer to the mainstream. "When the Farm Bill passed last year, we were beyond thrilled. This ended a multi-decade prohibition on hemp," Jonathan Miller, general counsel to an industry group of hemp companies, recently told NPR. "It was a historic moment."

Just as profound, however, has been the entrance of the US Federal Drug Administration into discussions around how hemp-derived CBD products are developed, sold and prescribed. These negotiations between industry players and regulators will serve as a template for how the wider US-based cannabis industry navigates its emergence from the cloud of regulatory uncertainty. In the years to come, there is potential to set upper bounds on the strength of hemp-derived CBD products developed for different end uses, which will provide ways to think about how to regulate THC products for the adult-use market on a unified national footing. Should that conversation fail to form, most analysts still agree that the coming years will witness further product differentiation and specialization into broad buckets, distinguishing pharma from consumer-facing health & wellness products alongside other various CPG offerings, including cannabis-infused cooking oils or beverages, for example.

Already, in states with adult-use regulations on the books such as California, changes in the consumption of alcohol have started to take shape. Cowen observed that, as of 2016, in the few states with a framework for adult use in place, incidence of binge drinking was reported with 13% less frequency per month than states with prohibition still in place. As these changes in consumer behavior continue to evolve and pick up speed alongside the shift in the status of cannabis to a firmer regulatory footing, incumbents from both Big Alcohol and Big Tobacco may look to buy rather than build even greater market share.

Even without federal legalization, the industry is building out on a quasi-national basis and establishing a strong foundation for itself. If cannabis use is legalized soon, it remains to be seen what will happen to the industry's current incumbents. In an important sense, the current cannabis industry has no real predecessor or model on which to guide itself. Cannabis has no playbook, and if it succeeds as an industry, it will owe much to the earliest companies and investors who are taking significant risks as we speak.