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Cannabis Business Combination Valuations

by Jamie Sieman, ASA, Principal

State approval of Cannabis products is on the rise in the US and there is a sense that the federal government is moving in that direction. The gradual legalization of Cannabis over the past couple of election cycles has led to rapid growth within the Cannabis industry, but the federal prohibition of Cannabis has handicapped the potential economic return of the industry since it is illegal to conduct Cannabis business across state lines and access to the services of federally insured financial institutions is not permitted. When the growth, sale, and use of Cannabis is no longer federally banned, expect local and multilocational Cannabis businesses within each state to be rolled up into super regional, national, and international enterprises, either as standalone businesses or as Cannabis divisions within larger agriculture, food, beverage, chemical, pharmaceutical, and tobacco companies.

CANNABIS TRANSPARENCY

US GAAP-compliant accounting, as directed by the Financial Accounting Standards Board ("FASB"), is an imperative for a large percentage of investors and for those operating in regulated industries. When discussing the accounting for the acquisition of businesses, one must keep in mind that the FASB's primary objective is to provide **transparency to shareholders and regulators**. When accounting for mergers, acquisitions, and other change in control transactions, acquirers are required to allocate the purchase consideration into various tangible and intangible assets for compliance with the FASB's Accounting Standard Codification ("ASC") 805 - ***Business Combinations***.

A purchase price allocation is a method of ascribing the total purchase consideration, including contingent consideration, over the "fair value " of the acquired assets and liabilities of the target. The difference, or residual, between the value of the identifiable assets and liabilities and the total purchase price is designated as goodwill.

In the Cannabis industry there are certain nuances, as well as tax regulations, that require consideration in performing a purchase price allocation. As with any purchase price allocation, the valuation specialist must identify and value not only the acquired working capital and tangible assets (fixed assets, inventory, real estate, etc.) but the acquired intangibles assets. In the Cannabis industry these can be somewhat unique. Revenue drivers of a Cannabis company tend to be their brand and licenses.

Intellectual Property

A company's internally developed Intellectual Property, although oftentimes not capitalized, are often key assets in mergers and acquisitions. Intellectual Property can be among the most valuable assets of a company. In the world of Cannabis, a company's Intellectual Property can include:

- Trademarks or Brands;
- Formulations; and
- Patented & Unpatented Technology.

The typical methodology employed to value licenses, due to their cash flow generating potential, is the **Multi Period Excess Earnings Method ("MPEEM").** This may or may not cause an issue given the company's revenue mix, either retail or wholesale, as another intangible asset, customer relationships, may also need to be valued.

Customer Relationships

The end product generated through the Cannabis cultivating process is typically sold in a retail environment, within a dispensary, and as such, a true customer relationship may not exist. However, some cultivators sell to the wholesale market and in this instance, there may exist wholesale customer relationships. Customer relationships are an intangible asset that need to be identified and quantified by the valuation specialist for capitalization on the opening day balance sheet resulting from a business combination. Customer relationships are typically valued under the MPEEM, but since the MPEEM is used to value the license, an alternative valuation methodology must be utilized to value the customer relationships.

Projected Cash Flow Tax Considerations

Until federal legalization of Cannabis is enacted, an important consideration in performing a purchase price allocation for Cannabis industry businesses is the tax treatment of the projected cash flows. **IRS Code Section 280E** addresses the operating expenses associated with running Cannabis businesses. Section 280E essentially penalizes Cannabis businesses by eliminating the benefit of expensing normal business expenses, expenses that every other business is permitted to write-off. This treatment has a significant detrimental impact on the discounted net cash flow analysis used by valuation specialists to determine the internal rate of return of the transaction consideration paid in a business combination. In addition, the intangible asset valuation analyses, which are primarily revenue or cash flow driven, are impacted in the same way by Section 280E. As such, this **industry specific nuance** needs to be considered when determining the appropriate effective tax rate to utilize throughout the purchase price allocation analysis.

As with any purchase price allocation analysis, the existence and proper valuation of identifiable intangible assets is based upon the valuation professional's knowledge of the specific industry and the proper identification of the intangibles at the outset of the engagement. For more information or a discussion about the valuation of a business, fixed assets, or real estate within the Cannabis, or any industry, please contact any of the professionals listed below.

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