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TRANSACTION ADVISORY

Know Your Worth: How to Value a Cannabis Company

The rollout of Canadian recreational cannabis has not been perfect. Similar to other nascent industries, early growing pains were expected—at least by some.

Between 2012 and 2018, cannabis entrepreneurs with the appropriate Health Canada licences and a plan in place experienced extraordinary increases in value. Since legalization came into effect in October 2018, however, the market has not been overly positive.

While the long-term growth potential remains promising for the cannabis industry, early sales have underperformed against expectations due to the following key factors:

- ▶ Pricing spreads with the grey market.
- ▶ Persistent supply issues, as quality continues to be a challenge in production.

- ▶ Significant under-saturation of privately held bricks and mortar retail operations (especially in Ontario, which comprises almost 40% of Canada's population).
- ▶ The absence of enticing new products, such as topicals, tinctures, or edibles.
- ▶ A lack of sustainable EBITDA and operational free cash flows.

As the cannabis industry and market change rapidly, the outlook, key risks, and valuations of companies operating in this space are experiencing significant volatility. It's more important than ever to have an accurate, legitimate business valuation to remain sustainable and attract investors, suppliers, customers, consumers, and employees.

In this article, we will examine key factors that investors consider in a valuation of a cannabis company.

Why does a cannabis company need a valuation?

Today, the cannabis industry is mostly equity financed because, as mentioned above, very few companies are actually profitable. Owners with a current outlook and valuation will have a better idea of who to approach with offers to invest, how to structure those offers, and what to do with the dollars raised to increase the company's value.



What factors drive the worth of a cannabis company?

Cannabis company valuations are based on a number of factors, both tangible and intangible. A qualified valuation advisor can help assess a cannabis company's current position, and will examine the following:

► Concept

The market is seeing a decline in the value of companies in the cultivation space and a rise in value of companies in the extraction or distribution space. Within the extraction/research space, value is gained with a unique concept that solves a specific problem or fills a specific need.

► Licences

Cannabis companies require proper licences for cultivation, production, and/or distribution, as well as certifications for facilities to export medical cannabis to international markets. By increasing the number and types of licences, a company can operate more freely under the Cannabis Act, which opens the door to diversification and may increase the company's value. For example, facilities that have the good manufacturing practices (GMP) certification are typically able to export to international markets and may attract a higher valuation.

► Capabilities

Cannabis companies can focus on cultivation, extraction, research and development, or a combination thereof, which means output metrics are critical. A company focused on cultivation, for example, needs to know how many square feet of growing space it has and how many grams per square foot it can produce. For those focused on extraction, the amount of kilograms processed per day is an important benchmark. Companies in the distribution or retail space should understand the unique supply and demand issues in a specific location, including its monthly throughput.

In addition to its current capacity, it's important to consider the possibilities for expansion. Will the cultivator have access to more space? Does the extractor have other products in the pipeline? Can the distributor leverage additional channels?

► A solid business plan

The cannabis industry is attracting a lot of people with ideas, but anyone can have an idea. A company with a clear vision of where they want to go and how they are going to get there is more valuable than a company with only an idea and no defined path. The vision should include a business plan that demonstrates an understanding of the industry, market, and regulatory limitations. In most cases, a plan should also include a reasonable valuation supported by a realistic financial outlook or projections based on industry and market metrics.

► Money in the bank

How much capital have the founders or management team invested? How much third-party capital has the company raised and where has this capital come from? A strong cash position and ability to access additional finances is critical for the success of most cannabis companies.

► The founders and the team

Belief in the people behind a company plays a large role in any valuation, but especially so in the cannabis industry because it's new, highly regulated, and subject to speculation. Have the founders demonstrated an ability to iterate and pivot? Does the management team have a strong background and documented success in similar fields? Are they individuals with integrity and a good reputation? Answers to these and similar questions can influence the market's perception, outlook, or view of risk as it relates to a cannabis company and thereby affect a valuation.

The investor perspective

To understand and communicate the value of your cannabis company, it's important to know the mindset of individual, strategic, and financial investors. They will consider a number of questions, including:

- ▶ What is my risk tolerance relative to the life stage of the company and the industry?
- ▶ Will I be exposed to regulatory or reputational risks?
- ▶ Do I like the leadership team? Do I trust them to execute the strategy?
- ▶ Do the financials, industry performance, and market trends support the company outlook?
- ▶ What is the current state of the capital markets?



▶ Retail strategy

As the cannabis production market becomes more saturated, investors may look towards retail. Retail licences for recreational use are handled at the provincial level. The Cannabis Act mandates that Canadian provinces regulate distribution of cannabis, including store licensing. Therefore, valuation fundamentals are based on the unique characteristics of each province.

Consider your overall retail strategy. Will you be a pure-play online or bricks and mortar retailer, or an omnichannel one? Which provinces do you plan to operate in? How will you develop your retail brand? Answering these questions can help you build a strong plan for business growth.

▶ Product diversification

As the market enters the Cannabis 2.0 phase, more products will be available to consumers, such as edibles, vape oils, or other concentrates. Cannabis company owners may see new opportunities for business expansion and growth by diversifying their products, which can ultimately lead to higher multiples.

What should cannabis business owners do next?

It's important to fully understand your company's strengths, areas for improvement or opportunity, and desired future state. Cannabis company owners should consider the following steps:

1. **Be proactive** - Whether you're building to sell or stay in for the long term, obtaining a proper valuation will help you create a timeline for yourself and avoid accepting an unfavourable deal.
2. **Understand the market trends** - Keeping up with the rapid pace of change and opportunity in the cannabis industry is crucial to maintaining value. Where international markets are going with their cannabis regulations, innovations in growing and cultivation, and the price of dried flower could all affect how you move forward.
3. **Engage a professional valuations advisor** - An experienced advisor can provide a realistic pricing target for your company. It's important to strike the right balance. A price that is too low is disadvantageous and potentially dilutes your ownership; one that is too high could deter potential investors. A credible valuation will also help you better market or explain your opportunity.
4. **Work on value enhancements** - Understanding your company's worth can help you increase operational efficiency and build on value drivers to improve revenue and earnings. When involved early in the process, a valuation consultant can help identify these drivers.

How BDO can help

BDO's team of chartered business valuers (CBV) has experience working with cannabis companies across Canada and international markets. We understand the industry and the issues that producers, retailers, and other industry stakeholders face. Our services include:

- ▶ Business valuations to support transactions, financing, tax structuring, and pricing analyses for M&A.
- ▶ Financial modelling, including comprehensive forecasts and business planning tools.
- ▶ Accounting advisory, including assistance with IFRS reporting requirements, purchase price allocations, contingent consideration valuations, annual impairment tests, due diligence, financial instrument valuations, biological asset valuations, etc.
- ▶ Tax planning and compliance.
- ▶ Consulting services tailored to the cannabis sector, including integrated business systems (ERP, CRM, etc.), data governance, SR&ED and government incentives, and business process enhancement.

To learn more, contact your local BDO office or cannabis@bdo.ca



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