Debt Financing for Cannabis Companies – A Market Update

Nov 17, 2017

By Graham Topa

In the April 6, 2017 edition of *Collateral Matters,* our article entitled *A "Green Rush" for Debt Financing?* canvassed some legal and business issues specific to debt financing of Canada's regulated cannabis industry. The "green rush" towards equity financing of the cannabis sector is well-known, but debt financing has lagged behind, notwithstanding that emerging business in this sector remains hungry for a non-dilutive source of capital.

This previous article explained how lenders face valuation challenges in circumstances where a borrower's collateral primarily consists of specialized equipment or cannabis inventory. Enforcing security held over such collateral, and realizing value from it, is challenging due to a limited resale market and to the fact that cannabis inventory is currently a controlled substance. Coupled with the current state of Health Canada's regulatory regime (which arguably makes it questionable whether a security interest can validly attach to a licensed producer's licence), there are a number of obstacles to debt financing of the sector, particularly for asset-based lenders.

Since our previous article, we are pleased to report that a number of lenders have increased their activity in the cannabis sector. Industry statistics provided by Viridian Capital Advisors LLC ("**Viridian**") show that, from Q1 through Q3 2017, approximately US$166 million of debt capital has been raised over the year to date by cannabis-related Canadian businesses. The Canadian debt dealflow as of the end of Q3 2017 is 46% higher than the entirety of 2016's debt financings (US$113 million).

While Viridian's numbers show that financing to Canadian cannabis businesses is on the upswing, equity remains their primary source of capital. Debt financings are roughly a quarter of the total capital raised. These statistics suggest that many businesses in this sector are significantly under-leveraged, which may be attractive for lenders considering the sector.

Debt financings for businesses in the cannabis sector are getting larger: globally, the average debt raise in 2017 as of the end of Q3 is US$4.3 million, whereas the average debt raise in 2016 was US$0.7 million.

The 2017 Canadian data is largely driven by a record-setting Q2. Q2 2017 featured a $20 million credit facility from an undisclosed Canadian bank in April, a $25 million term loan made to Aphria from WFCU Credit Union in May, and a $40 million construction financing facility offered to Cronos Group by Romspen Investment Corp.

In particular, observers are reacting to the Cronos Group financing as a watershed moment for the industry's access to term debt capital. In a recent post in *Marijuana Business Daily* (in which the authors of this article are quoted), Beacon Securities analyst Vahan Ajamian calls it a "total game-changer" for the market. Although the sample size is small, the 2017 data indicates that lending to Canadian businesses in the cannabis sector is on the rise.

Perhaps unsurprisingly, many of the notable Canadian debt announcements came from borrowers in this sector with substantial real estate assets, cultivation and production facilities. The 2017 Canadian data (particularly from Q2 2017 and Q3 2017) suggest that, even more so than in other industries, real estate assets may be critical to a cannabis borrower's risk profile. An interesting question, then, is whether lenders are becoming more confident in the sector's future potential, or whether the Q2 2017 spike was simply due to a few borrowers offering major real estate assets as security.

Canada's cannabis sector dealflow is also being driven by stream financing. Most commonly seen in the Canadian mining sector, streaming is a creative, non-dilutive financing approach that typically has some features of equity (most notably, upside participation), but is most appropriately considered as debt. Streaming involves the issuance of debt obligations that are repayable in product or product equivalents, with such repayment contingent on actual production. Using the gold mining context as an example, a streaming investor will make an up-front payment to a mine to invest in exploration activities, with a contingent right to receive gold or proceeds of gold sales if sufficient gold is produced within the term.

One of Canada's more prolific streaming investors is Cannabis Wheaton Income Corp., which recently announced a $10-million offering of non-dilutive financing to Beleave Inc. to fund the expansion of its cannabis production facilities. The cleverly-titled financing instrument used in this offering is a "Debt Obligation repayable in Product Equivalents," or a "D.O.P.E. Note", to be repaid from the proceeds of Beleave Inc.'s future wholesale or retail cannabis sales once such sales exist.

The recent uptick in non-dilutive financing is good news for the cannabis industry's growth prospects, particularly in the cultivation vertical, where property, plant and equipment financing is critical to growth (both literally and figuratively).

A recent *Globe and Mail article* suggests that Canada's big five banks are warming to the cannabis sector and related industries, with some insiders suggesting that large-scale institutional debt capital could be a reality in the near to intermediate future. However, at the moment, establishing even basic commercial banking services (including cash deposits, cash management and operating lines of credit) remains challenging for entrepreneurs in the cannabis sector.

With a four-to-one ratio leverage ratio in favour of equity, and a national cohort of sophisticated businesses who are seeking to acquire/expand their production and distribution facilities, the Canadian cannabis sector appears ready for lenders to enter, particularly alternative or asset-based lenders. While taking and enforcing security over personal property remains challenging in this sector, some borrowers have risk profiles that can overcome these issues, and lenders are becoming more comfortable with creative structures such as streaming that mitigate some of the issues, particularly the issue of controlled substance inventory.

As the regulatory environment for recreational cannabis matures, we, like others, will be watching the market for non-dilutive capital closely.

* *This article was co-authored with Timothy Jones, formerly of Aird & Berlis LLP.*

Author

Graham Topa
Partner
T 416.865.4739
gtopa@airdberlis.com

AIRD BERLIS