

Marijuana Field of Dreams: The Do's and Don'ts for investing in Pot.com

- ❌ Making money off the pot.com rush is going to be extremely difficult for the average investor.

Here in Part 3 of this series we look at practical ways to balance your risk and potential return (Part 2) when investing in the inevitable wave of decriminalized cannabis (Part 1).

I've read approximately 60 business plans in the hemp and marijuana space over the past 9 months or so, and met with numerous management teams / promoters. Here is my evolving basic list to ask the cannabis companies:

- 1. Do you have the licences necessary to legally grow / transport / sell / process cannabis?** If the answer is no, then generally the company isn't worth very much. Yes, there is a chance that the company will eventually get a licence, but that's a huge risk to take with your money. It will take months if not years for overwhelmed bureaucracies to create processes, review the applications, write back to point out deficiencies, follow up on the deficiencies and eventually get around to issuing licences. Not every company that applies will get a licence. Not every company that applies *deserves* a licence. The risk that the average investor must take is immense, compared to the possible return. When the answer to this question is no, the follow-up position from the company often is, "We don't have a licence, but we're pre-licensed". *Pre-licensed?* Is that like being "pre-pregnant"? This hollow term means they submitted their application and are waiting to see what happens. Just giving it a name doesn't decrease the risk or increase

your potential return.

2. **What is your prefinancing valuation?** Another way of putting this is, what's the company worth, as is, where is, today. Most of the prefinancing valuations are indefensible. Here's an example. I met with a private group (let's call them WannaWeed) looking to get a medical marijuana licence in one of the states. WannaWeed had a lot of no, as in no cash, no land, no building, no expertise, no medical experience, no regulatory affairs experience, no security plan, no star power on the board. The balance sheet was all liabilities and a deficit, with no assets. And yet, management valued the "opportunity" at around \$8M, prefinancing. I couldn't help myself – I had to ask how they got that number. The answer back was based on the size of the US market ("It's worth billions!!!"), their expected market share ("We expect to sell to over 5% of that market!") and an expected price per gram ("We'll sell quality strains so we'll sell around \$8 a gram!!!"). You could hear the exclamation marks when they talked. So another no for WannaWeed was that they made no sense. That company is worth, well, no. To date they haven't raised any capital and aren't listed anywhere.

3. **Marketing** Think of how much advertising you see for the "sins". Alcohol, Las Vegas as a whole, the casinos individually, tobacco ... all driven by massive marketing budgets. The cost of customer acquisition is huge, and that's a question you need an answer to. What's your marketing plan and budget? The cannabis companies will have to raise mammoth amounts of capital to drive their marketing efforts. How much will it cost for Nabisco (the official cookie sponsor of Nascar) to see its new 'brownie' advertised on a car roof?

Raising that capital will greatly dilute the shareholders, and their financial fate then rests in the hands of the marketing team. Marketing is a gamble at

the best of times. An early failure to attract users will mean no revenue against large expenses, which means the company will die. Goodbye, investment.

This is the part of their business plans that the weedco's seem to want to discuss the least, probably because it's the hardest to nail down. The legislation governing advertising is still evolving and will change over time. One weedco told me (and actually seemed to believe) that their strains will be superior to every other medical strain available, so they will be able to charge a premium, limit their supply, and not have to spend marketing dollars. Again, this reminds me of the failed high tech companies that had a doomed, "if we build it they will come" mindset.

4. **Management** Who is involved in the company? Does the CEO have any experience as a CEO? What's the track record of creating shareholder value? What is the executive compensation? Who is responsible for raising capital? Who is head of marketing? How deep and varied are the board's skill sets? Is this a family business looking to use public money to advance the family, or is there a real board of directors with real independence? Even armed with good answers to those questions, I don't think any investor, whether professional or a do-it-yourselfer, has any chance today of picking tomorrow's winners. Without a doubt, there is a Mark Cuban and Broadcast.com hiding in the weeds out there, but I have no idea which of the thousands of start-ups it's going to be. *Someone* will be a winner, and it's easy to eliminate the obvious losers, but after that it's a crapshoot.

So, if you're convinced you need some investment exposure to this market, understand this is very high risk investment in a newborn industry. Use the same approach as you would in other high risk industries:

- **DON'T invest without a knowledge of the field.** *DO educate yourself* as to cannabinoids generally and CBD in particular, THC, oil, different government regulations, licence terms, milestones and the industry participants. Knowledge is power.
- **DON'T invest in only one company.** *DO invest in a portfolio of companies. Spread the risk.*
- **DON'T invest in only the growers and wannabe growers.** *DO divest into the infrastructure companies such as security, fertilizer, distribution, food, services, third party testing and medical buildings. Again, spread the risk.*
- **DON'T ignore the audited financial statements.** For example, Supreme Pharmaceuticals (a wannabe grower) shows about \$8.4 M of very soft assets on its balance sheet for something called "Licence Acquisition Cost". Note 3 to the financials shows this is just the net cost of buying a licence, but I can't find an explanation of what that licence is for! I assume it was the net purchase price to buy the company that has applied for a grower's licence, so that just represents someone else's sunk costs that have not yet resulted in a licence from the government. Remember, don't go broke, go public! But, at the same time, Supreme does own real assets on its balance sheet, being about \$4.7M of land and buildings. There is some downside protection in those hard assets. If Supreme fails to get whatever licence it applied for, at least it still owns that real estate and can do something else with it for the shareholders.
- **DON'T be the first outside investor.** Cash is king, and most of the companies I've seen don't have anywhere near enough cash. That's why they're making the rounds. *DO wait until the balance sheet has some strength and management has finalized its compensation package.*
- **DON'T take management's story at face value.** Driven by hype and hope, and given the early stage of the industry, it won't be possible for even credible

management to have all the answers. DO ask a lot of questions and be prepared to walk if you don't like what you hear. Trust your judgment – if it sounds dumb, it probably is. Talk to the suppliers, employees, independent directors. Realize that there will be very good promoters with very bad deals.

- **If it's a private investment, DON'T just accept management's initial valuation of their dream.** That first valuation offered to you will be excessive. DO be prepared to walk away from the deal. Remember deals are like streetcars and another will be here in 10 minutes.
- **If you're buying shares on a stock market, DON'T be rushed into buying today.** Look at the number of shares outstanding and figure out the market cap. If it's too high, wait. Like all markets, prices will go up and prices will come down. If you really like the company and you understand the answers to your questions, wait until the potential return on your investment matches up with the risk you're taking. In mining, success is just one drill hole away – the problem is, you don't know whether it this hole or the next one or the hundredth one. The same theory applies here. *Take your time.*
- **When the inevitable happens and some of your portfolio holdings fall, DON'T be afraid to sell.** DO be willing to sell and walk away, and roll over into a better opportunity. Taking a small loss today is far better than taking a massive loss a year from now. Having invested in a portfolio of companies gives you that ability.

Good luck!