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California: Lessons from the World's Largest Cannabis Market

EXECUTIVE SUMMARY

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The Best of Times… and the Worst

California has long been a state of superlatives—often first, usually largest, sometimes worst. This holds for its cannabis industry. California was the first to legalize medical cannabis, with the passage of the Compassionate Use Act of 1996 (aka California Proposition 215), and that market grew to nearly $3 billion in annual spending by 2017, the biggest in the world.

Then, another first (this one was no reason to celebrate): in 2018, California become the first state to manage to shrink its legal cannabis industry by allowing all adults to legally buy at dispensaries. Annual legal cannabis spending in the state slid to just over $2.5 billion in 2018—the direct result of burdensome regulations and taxes, recalcitrant or unprepared county and city authorities and a host of other issues detailed in this report.

California Market Summary

2019 Population	40.2 million
2019 21+ Population	30.1 million
2019 Legal Spending	$3.1 billion
2019 Illicit Spending	$8.7 billion
2024 Legal Spending	$7.2 billion
2024 Illicit Spending	$6.4 billion

Source: Arcview Market Research/BDS Analytics

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As some of the kinks of the transition get worked out, and California's legal cannabis market is forecast to surpass its 2017 high-water mark in 2019, generating nearly $3.1 billion in spending. The latter half of 2018 and the beginning of 2019 have seen considerable improvement in the state's industry fundamentals, including the growth-critical retail footprint in the major municipalities.

Investors and out-of-state operators who had turned their attention to what will always be smaller markets elsewhere have shifted their focus back to the Golden State. That makes sense given the forecast that legal cannabis spending in California will grow at a 19% compound annual growth rate (CAGR) to $7.2 billion in 2024, 40% larger than Canada and 253% larger than the next-largest state, Colorado. That is why the state has seen billions in merger and acquisition activity between October 2018 and June 2019, a time during which Canadian licensed producers (LPs) and Eastern multi-state operators (MSOs) have seen their stocks crater.

But the lessons learned from the California launch provide many object lessons for legalization advocates, regulators, operators and investors. The load of new regulatory demands and taxes in the enabling Prop. 64 passed in November 2016—or layered on afterward—brought on two "waves of extinction" that crashed through all segments of the supply chain.

The first came shortly after the Jan. 1, 2018, launch of the adult-use market that was accompanied by a significant decline in dollar sales, and thousands of business failures—or decisions—to go rogue. The second came in July 2018, with the implementation of the highly stringent Category II lab testing, leading to a dearth of product and another surge in business failures.

A unique feature of the California market that contributed to these dives in top-line sales figures is the robust competition from the illicit market with which licensed retailers are forced to contend. Given the state's lengthy history as the source for the bulk of the nation's illicit cannabis, and the fact that many producers and retailers opted not to enter the regulated market due to compliance costs, Californian consumers have no shortage of cheap illicit sources for their cannabis. They rushed into dispensaries amid

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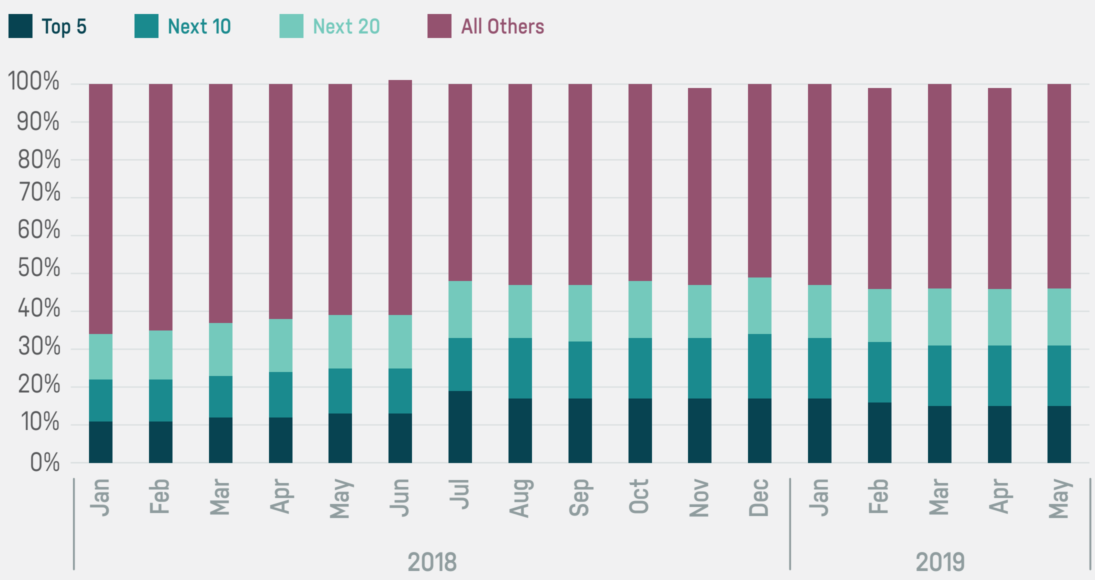
While sales did take a major hit from their peak in 2017, retailers who were early movers into the regulated system were able to grab much bigger pieces of this smaller pie

the hoopla of long-awaited legalization and then quietly returned to traditional sources when they saw after-tax prices reflective of the 77% tax-and-regulatory load the legal market bears.

For those operators who did opt to enter the regulated market, however, the top-line sales figures from 2018 do not tell the whole story. While sales did take a major hit from their peak in 2017, retailers who were early movers into the regulated system were able to grab much bigger

Market Share by Brand Band



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pieces of this smaller pie. The numbers of retailers fell much more significantly in 2018 than statewide legal revenue, giving a boost to those still active after the transition and setting them up to gain even more market share moving forward (see "Eighteen Months into Legalization"). Some brands were able to similarly capitalize off the July shake-up, as supply chain disruptions allowed leaders to gain market share, especially against generic flower products unprepared to meet new packaging requirements.

Given this silver lining to the stormy launch of adult-use, as well as the fact that the market has resumed growing after the wrenching reset of 2018, California is a renewed target for many large-scale investment projects (see "Co-op Conversion: Cannabis Goes Corporate"). Out-of-state vertical MSOs are seizing the California opportunity through supply-side brand acquisitions, as with Illinois-based multistate operator Cresco Labs' acquisition of Origin House or Curaleaf's all-stock deal to acquire top California concentrate brand Select Oil.

With a population of 40 million, and a $2.7 billion gross domestic product (bigger than all countries other than the U.S., China, Japan and Germany), the California market is a microcosm of national battles for market share to come in cannabis. The state has counties and individual cities bigger than many U.S. states. Cultivators, manufacturers, distributors and retailers are amassing local licenses and developing strategies to compete for markets across the whole state and—with federal legalization—the whole country and the world (see "Regional Diversity: Panning for Gold").

When that day comes, operators and investors elsewhere will need to be prepared to compete with companies having California's many advantages in terms of agricultural infrastructure, tech-development pipeline and media-based branding prowess. In the meantime, there are many lessons to be learned and applied locally from the launch of adult-use sales in the world's largest cannabis market.

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Letter From the Editor

Forecasts matter, as it turns out. Had California cannabis companies not geared up for the doubling of revenue seen at the advent of adult-use legalization elsewhere, more of them might have avoided the dual "extinction events" of January and July last year.

Let me eat some crow myself: Despite our team's decades of experience forecasting other nascent industries, we too were blindsided by the unintended consequences in the fine print of the regulations that eventually emerged from the Bureau of Cannabis Control. The transition to adult-use sales had gone so well in prior states that we underestimated the drag on legal sales that California's local bans, high taxes and expensive compliance requirements proved to be. In an $11.3 billion total cannabis market of 2017, $8.3 billion was already being spent in extra-legal channels. For the first time anywhere, adult-use legalization actually prompted growth in illicit sales in California in 2018.

The rest of the cannabis industry can learn much from the California experience (see the discussion of our Growth Indicator Matrix in "Factors Impacting California's Future").

The most important of those lessons are ones California's governing class needs to learn too:

- Tax rates may or may not affect consumer behavior in general, but they certainly do when they are set at high levels on a product widely available through an established illicit pipeline.
- Justifying those taxes by promising to use the money for enforcement action against illicit operators is not credible for two reason:
  - If enforcement worked, the 40-year War on Drugs would have proved it.
  - Enforcement is anathema to an industry being legalized largely around agreement that no adult should be arrested, lose their property or even have their kid ostracized at Little League over involvement with cannabis.

Essentially, regulators need to get past their Prohibition-era prejudices: There would shortly be no more illicit market for cannabis than there is for liquor if regulations for the two products were the same, i.e. testing to keep out harmful chemicals and checking IDs at stores. The rest is regulatory overreach.

Every legalization event going forward will be different from the big ones so far—Colorado, Washington and California—but the lessons learned from California's wrenching first 18 months can help prevent them from being extinction events elsewhere.

Tom Adams
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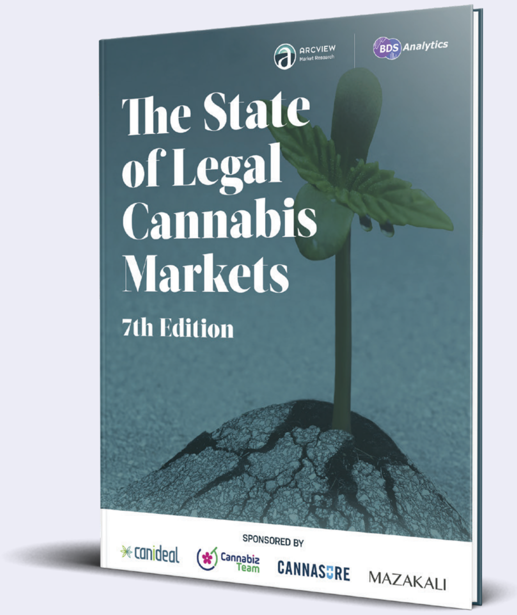

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