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EMERGING INDUSTRIES

Canadian Cannabis Production and Research Facilities

In 2001, Canada was the second country in the world to recognize the medicinal benefits of cannabis and to implement a government run program for medical cannabis access. The legislation has evolved since then and, on October 17, 2018, Canada was the first G7 country to legalize recreational cannabis coast to coast. In Canada, the number of licensed producers since 2015 has increased from 26 to 142 and the number of registered users since the second quarter of 2017 has grown from 174,503 in the first month to 342,103 as of September 2018 (source: *Health Canada*). Dried cannabis consumption has levelled off, while cannabis oil consumption in Canada has increased quarter over quarter for the last four quarters, with September 2018 levels sitting at 5,985 kilos (dry) and 13,156 kilos (oil) respectively.

The total cannabis market in Canada, which includes medical, legal and illegal recreational products, is expected to generate up to \$7.17 billion in sales for 2019. It is anticipated \$4.34 billion of which is forecast to come from the legal recreational market. Medical cannabis is anticipated to generate an additional \$0.77 billion to \$1.79 billion in sales, with the illegal market

Sample Production Flow



forecast to achieve \$0.51 billion to \$1.04 billion (source: *Deloitte 2018 Cannabis Report*).

From an appraisal perspective, the Canadian cannabis business is one that uses real estate in the process of producing its products; however, due to the specialized nature of the business, the security available to lenders consists of much more than real estate alone, and, from a valuation perspective, it is essential to provide lenders with a clear understanding of the security value of the land and buildings (conventional assets for appraisal), equipment (specialized production, research and packaging), biological assets (mother plants), business goodwill and Health Canada licences.

A cannabis company's ability to grow, store, manufacture by-products and sell cannabis in Canada is dependent upon licences from Health Canada, which are subject to ongoing compliance and reporting requirements; and secondly, on the willingness of lenders to provide financing for research and expansion. Access to capital for medical cannabis producers was somewhat limited until 2018, but it is evolving, especially in Canada, since legalization of recreational cannabis use passed on October 17, 2018.

FACILITIES

Cannabis production and research facilities are highly specialized, generally consist of well-built concrete/steel or pre-engineered steel structures and are sub-divided into production and production support areas. A cultivation and production facility includes substantial and intricate mechanical systems, growing rooms (including mother rooms), clone rooms, pre-veg rooms, flower rooms, drying rooms, trimming room, extraction lab, packaging room, laboratory, packaging, storage including onsite vault, shipping, security offices, executive offices and staff areas. Some facilities also have patient support call centres.

These facilities have high level security protocols that require both access control and video surveillance securities to monitor the building perimeter and all critical spaces within the building; each room must be equipped with card readers. There must be 24-hour security systems in place and, generally, physical access to the buildings is via turnstile security gate with scan/card access along with security desk authorization for visitors. The front security/

reception rooms are equipped with bullet-resistant glass and house both the access control and video surveillance workstations.

The growing rooms are equipped with intelligent grow lights that replicate the parts of the sunlight spectrum that the cannabis plants need at each stage of growth. Air filtration and circulation systems will control heat build-up and eliminate exhaust odors. There are also various irrigation systems for growing cannabis including drip irrigation, hydroponic flood benches and trough benches. The irrigation systems are designed in conjunction with a nutrient management system for maximizing the production yield of the cannabis plants. Computer control systems monitor and control all the nutrients, lights, air circulation and irrigation needs of the plants, and are designed to maintain the exact environment needed for the different growing rooms, cloning rooms, flowering rooms, etc.

APPRAISAL ASSIGNMENTS

Most of my appraisal assignments have been for state-of-the-art medical cannabis production and research facilities in British Columbia, Manitoba and Ontario and, increasingly, since legalization of recreational cannabis in the fall of 2018, we are seeing a variety of site improvements including specialized greenhouse facilities located in rural areas, many of which have been converted from pepper cultivation to cannabis cultivation. (So, if you have noticed a shortage of fresh local peppers in BC, Ontario and Quebec, this is likely why.)

In addition to real estate appraisal, I have also partnered with Chartered Business Valuator (CBV) specialists on the package valuation of the entire assets, including business and equipment valuation; however, the focus of this article is to provide a general level of appraisal issues surrounding the specialized real estate value of land and buildings and their contributory worth to the production operation, specifically 'value in use' of modern medical cannabis production and research facilities.

Value in use is appropriate for specialized properties where there are limited alternative uses. This is a value concept, which is based upon the productivity of an economic good to its owner-user.

The application of value in use premise is generally appropriate when:

- The property is fulfilling an economic demand for the service it provides or which it houses.

- The property has a significant remaining useful life expectancy.
- There is responsible ownership and competent management.
- Conversion of the property to an alternate use would not be economically feasible or legally permitted.
- Continuation of existing use by present or similar users is practical.
- Due consideration is given to the property's functional utility for its present use.

From an appraiser's perspective, it is important to make clear to the reader of your report that the conclusion of value will not necessarily represent open market value or value in exchange if the asset were to be disassociated from the intended business operation for which it was designed.

Also, due to the lack of market transactions in this sector, the highly specialized nature of the property, as well as the infancy of the industry in Canada, an important contingency of my reports is the assumption that the subject improvements are dependent upon the profitability of the business for which they were intended (i.e., medical cannabis production and research facility) and are producing sufficient revenue to support the replacement cost, while providing an appropriate investment yield. (Many of these medical cannabis producers have had a history of annual net losses due to focus on expansion in anticipation of meeting the needs of Canada's recreational market that was legalized in 2018 and also entry into European countries where medical cannabis is legal or is anticipated to become legal.)

To establish value in use, my reports have focused upon the cost approach, which is based upon the principle of substitution, in that it involves estimating the cost to reproduce the improvements, plus adding the value of the land as if vacant.

CHALLENGES/CONSIDERATIONS

Medical cannabis production and research is still an emerging industry. The recreational cannabis industry in Canada has an even shorter history with high levels of risk and volatility, as well as complex and specialized facilities and equipment, with most if not all facilities owner-occupied or occupied by non-arm's length entities, so sale information is very limited.

The regulatory structure in Canada will continue to evolve and change, especially with the legalization of Cannabis edibles in Canada in 2019.

Locations vary and may be within city boundaries, typically in industrial areas, however, they are predominantly located in rural and remote locations that are agricultural in nature with limited municipal services, though the upside is usually lower property taxes and operating costs.

There is not always an abundance of comparable vacant land sales within or near rural areas where the facilities are located.

There are many moving pieces, including the Health Canada licensing process, as new projects take time to get off the ground. Projected costs and current and projected financial statements are often moving targets. For existing facilities, key considerations are: does the business appear to be producing a profit and, if applicable, is there steady patient growth?

There is limited information on cost to construct similar facilities within the market area.

Remote locations can be time-consuming to inspect, sometimes involving flights with multiple stops/connections each way, and car rental.

ZONING, HIGHEST AND BEST USE

To accommodate demand and attract development of cannabis production facilities, municipalities across Canada have revised existing zoning bylaws to allow for cannabis production and/or enacted site-specific legislation to accommodate the intended use of the cannabis producers. Generally, the highest and best use of these properties is as licensed producers of medical cannabis under ACMPR (Access to Cannabis for Medical Purposes Regulations) guidelines. Presently, Health Canada licences are issued for one or all of three uses: sale (medical), processing, and cultivation. The territory in which the licence holder is authorized to sell cannabis products to authorized distributors/retailers and patients is qualified provincially/territorially. Licences are further limited by product type: plants/seeds, dried/fresh, oil, or none.

FINAL NOTE

There are circumstances where an income approach to value may be applied, e.g., when facilities are located in a major urban centre (usually outlying industrial areas of the city) and there is adequate market data available for built-to-suit single-tenant industrial and/or special purpose-built facilities that can support a cap rate estimate and an economic rent calculation. (It is not unreasonable to conclude that, were the space to be tenant-occupied, the cost of development, including developer's profit, would be factored into the terms of a new lease and likely over a 15- to 25-year term.) Using recent leasing activity for built-to-suit facilities that would be considered somewhat similar to the subject space would likely assist in supporting the economic rental rate calculation for the subject production facility.

This type of analysis is often requested by the lender and done in conjunction with the cost approach and is provided in support of the cost approach rather than serving as the primary approach to value.

As the cannabis industry continues to evolve, and with institutional lenders getting on board now that recreational use is legal in Canada, there are more and better options for producers in terms of expansion/growth financing. As well, the wider commerce community is recognizing more business opportunities, particularly the commercial real estate sector, now that the recreational market is legalized. 📌