Calif. Policymakers Should Aid Crashing Cannabis Market

By **Michelle Mabugat** (August 4, 2023)


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California's cannabis industry is in the throes of a financial crisis that has left many questioning its viability.

Tales of debts skyrocketing, tax burdens weighing heavy and businesses teetering on the brink are becoming all too common. All the glitter of the so-called green rush has faded, replaced by a harsh reality check.

If the current trend continues unaddressed by policymakers, the industry might be staring down the barrel of a major collapse.

Given the severity of the situation, it may be time for the state government to seriously consider potential bailout programs for the embattled industry.

While A.B. 195, which became effective on Jan. 1, halted cultivation taxes indefinitely — a move seen positively by many — it had unforeseen adverse effects on retailers.[1]

The bill, which suddenly shifted the burden of remitting excise taxes from distributors to retailers, posed significant challenges for retailers, particularly in terms of cash flow.

Previously, in an act of desperation, many retailers had been using excise tax collections as a way to bridge their cash flow gaps due to their limited options for traditional financing as a result of federal restrictions.

However, A.B. 195's recent tax payment change removed this financing model for cash-strapped retailers. What was initially thought to be a relief measure for cultivators ended up creating a different set of financial stressors for the industry's retail segment.

As a result, over 13% of the state's retailers were unable to meet the May 1 deadline for excise tax payments,[2] exposing them to 50% penalties and further worsening their financial difficulties.

The challenges extend further up the supply chain, leading to a significant reduction in the number of brands. Some industry experts have estimated that, in just one year, the number of brands in the market has decreased from nearly 1,500 to less than 1,000.[3]

State operators are also grappling with a significant unpaid debt bubble that, according to an estimate cited by California Assemblymember Phil Ting, D-San Francisco, exceeds $600 million across California's supply chain.[4]

At the heart of the crisis is the overtaxation of the cannabis industry. The cannabis industry, like any other, is heavily regulated by taxes. But imagine juggling a tax rate that can range from 45% to 80%: That is the reality for cannabis businesses operating in California.

This is due to the onerous state and local cannabis tax rates, as well as the effects of Title 26 of the U.S. Code, Section 280E, which denies credits and deductions other than cost of goods sold on any amount incurred during the taxable year in carrying on a cannabis trade or business.

Adding to the tax turmoil is a maze of regulations that California cannabis operators must navigate. From strict licensing requirements to ever-changing state and local regulations, the California model has created an environment fraught with financial pitfalls. The cost of staying compliant is growing, leaving operators struggling to stay afloat financially.

The legal framework surrounding the cannabis industry in California is proving to be a double-edged sword. On one hand, it provides a structure for businesses to operate within, but on the other, it seems to be choking the life out of the very industry it seeks to regulate.

The state's stringent regulations and high taxes have created a fertile breeding ground for the thriving illicit market. For instance, with state and local tax rates reaching an alarming 30%-40% on product sales, the price disparities have made it nearly impossible for legal retailers to effectively compete with their illicit counterparts that do not pay taxes.

The numbers, in fact, are startling. According to a 2022 report by the Reason Foundation,[5] the illicit market accounts for roughly two-thirds of total cannabis sales in the state.

Another major factor contributing to the illicit market is the power of local control. Under Proposition 64,[6] which legalized adult-use marijuana in the state, local governments may choose to opt out of allowing any form of cannabis businesses to operate within their local borders.

As a result, despite the fact that five years of state legalization have now passed, over 60% of California's cities and counties continue to prohibit cannabis retail operations.[7]

Ironically, these opt-out jurisdictions, in their attempt to ban cannabis, have unintentionally fueled the only available source for their local population to acquire cannabis — the illicit market.

The state itself has acknowledged this issue, with the Department of Cannabis Control stating in a press release that the "lack of access to California's legal cannabis marketplace threatens consumer safety and perpetuates the illegal market."[8]

The financial strain on California's cannabis industry is sending shock waves through the state's economy. The dwindling revenue is not only affecting local businesses, but also leaving a gaping hole in the state's coffers.

Indeed, the revenue shortfall is threatening the implementation of state-funded social equity programs designed to help individuals and communities disproportionately affected by the war on drugs. In a further twist of irony, an industry that was to be a beacon of social justice is now at risk of perpetuating economic disparities.

Disheartened by the financial chaos, investors are pulling back the reins on the cannabis industry.

After 2021's record-breaking year for cannabis mergers and acquisitions and capital raises,[9] there has been a stark shift in the capital market. It now carries an air of extreme caution, leading to depressed valuations and reduced deal volume.

As a result, there has been a marked decrease in liquidity, making it more challenging for companies to access capital and for investors to exit their investments.

Amid this bear market, the specter of insolvency looms over many cannabis companies, regardless of their size.

This is made evident by the stunning collapse of Herbl — a cannabis company that was once known to be one of the state's largest distributors. Herbl reportedly handled $700 million's worth of product sales in 2022,[10] but now finds itself in receivership after defaulting on its loan obligations to its main lender, East West Bank.

The final outcome for Herbl has already been outlined in the conditions of its receivership; Herbl's assets will be liquidated, with priority being given to the distribution of net proceeds to East West Bank and the settlement of outstanding taxes.

This suggests that brand vendors, some of which have already filed lawsuits against Herbl, will be unlikely to collect on potentially millions of dollars in unpaid invoices from Herbl.[11]

Meanwhile, in a self-perpetuating cycle within the supply chain, Herbl is filing collection lawsuits against various retailers in an effort to collect on unpaid invoices from retailers.[12]

The Herbl receivership is a grim reminder of the precarious situation many stakeholders in the cannabis industry find themselves in, and the urgent need for legislative intervention. Herbl's downfall is not an isolated incident, but rather a symptom of the structural challenges of operating in California.

Without comprehensive policy reform and targeted tax breaks, the receivership of Herbl could be the canary in the coal mine for the California cannabis industry.

The industry's plea for major reform has been echoing for the past five years. If left unheeded, we might be on the brink of a significant collapse, the ripple effects of which are just starting to surface.

And yet, every cloud has a silver lining — at least for some. Amid this financial turmoil lies a hotbed of opportunity for those with access to capital and a high tolerance for uncertainty.

Those looking to increase market share are leveraging the tumultuous market through strategic acquisitions at rock-bottom prices, frequently through distressed M&A, workouts and restructuring.

With the market being inundated with distressed assets, prices have taken a significant dip. Strategic buyers are buying low and holding on, anticipating that if and when the chaos dissipates, they will have a more dominant position within California's cannabis market.

High interest rates and the resulting increase in the cost of acquisition funding have also reshaped traditional M&A deal structures within the cannabis sector.

Gone are the days when M&A deals were dominated by substantial cash payments, sometimes making up more than half of the transaction's value. In today's market, buyout structures are now trending toward stock payments.

The most prominent case in point is the recent merger of TPCO Holding Corp. and Gold Flora in an all-stock deal valued at $34.8 million.[13]

Ultimately, the challenging financial landscape of California's cannabis industry calls for swift and targeted action from policymakers, yet in its current state, it also presents strategic buying opportunities that require little to no cash.

As the industry continues to evolve under these harsh conditions, the survivors and new entrants who can effectively navigate the shifting sands of risk and opportunity will ultimately shape the future of the cannabis sector.

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[4] https://reason.com/wp-content/uploads/2023/05/202320240AB766_Assembly-Appropriations.pdf.

[5] https://reason.org/wp-content/uploads/impact-of-california-cannabis-taxes-on-legal-market.pdf.

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