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Joint venture: Hedge funds roll up for the 'green rush'

By *Miluska Berrospl* on March 20, 2019

Looking back at the early 20th century, it is hard to imagine a time when a now-ubiquitous substance was illegal in the US.

Much In the same way the power of the states played a role in the prohibition era, many are quick to liken the cannabis industry's trajectory to the growth of the approximately $240bn alcohol industry.

Global marijuana sales are estimated at $17bn for 2019, according to cannabis trade analysis firm Arcview Market Research. That is an increase of approximately 38%, from around $12.2bn in 2018.

In the US there are 33 states that have approved medical marijuana and 10 that have approved recreational marijuana, with at least eight states, including New York, Connecticut and Illinois, expected to legalise it this year. In June 2018, Canada became the first G7 nation to federally legalise marijuana.

The so-called 'green rush' has been gaining steady traction with many interested investors flocking to the industry.

US venture capital activity in cannabis has skyrocketed from around 12 closed deals, representing about $16.3m, in 2013, to a very significant 117 deals closed, representing around $908m, in 2018, according to research from Seattle-based data firm PitchBook.

Although there are only a handful of cannabis-focused hedge funds, prominent people in the industry, such as Omega Advisor's Leon Cooperman, who has a personal investment in cannabis, and Tiger Global's Chase Coleman, are invested in the space.

On 13 March, Aurora Cannabis, a Toronto-based cannabis producer, hired former Trian Fund Management founder Nelson Peltz as a strategic adviser to its board, pushing its stock to soar over 10% immediately following the announcement. And like the crypto world, the cannabis industry also has its share of celebrity investors.

Cannabis enthusiast, rapper and entrepreneur Snoop Dogg (real name Calvin Broadus) co-founded West Hollywood-based venture capital firm Casa Verde Capital (which translates to 'green house'), which raised $45m before closing to new investors in March 2018.

Tiger Global last year joined Casa Verde in backing Green Bits, a developer of compliance software for marijuana businesses.

By all counts, interest in cannabis-dedicated funds has risen and returns are profitable, with some funds returning as much as 50% this year so far. However, getting off the ground for these types of funds remains challenging as many service providers, banks and institutional investors are still cautious about entering the space.

The hurdles for managers looking to launch cannabis hedge, venture, private equity or ETFs surpass the normal hurdles for start -ups, given the nascent nature of the industry and the legal uncertainty.

HFMWeek spoke to industry leaders, participants and managers to understand how funds approach launching a cannabis strategy in a turbulent, unpredictable but profitable market.

The service provider problem

Managers looking to launch a cannabis-dedicated fund can expect to face a mountain of rejections and plenty of uncertainty In finding service provider relationships, especially banking.

"Even trying to find a law firm to handle our documents for us was a real challenge in the beginning; says Morgan Paxhia, co-founder and managing partner of Poseidon Asset Management.

One client initiated discussions with 40 different banks and was rejected by all of them Poseidon runs approximately $100m in AuM. The hedge fund invests in public and private equity, debt and real estate in the cannabis space was launched by Emily and Morgan Paxhia in 2013 in San Francisco.

California was the first state in the U.S. to make medical marijuana legal in 1996, through Proposition 215. Some 20 years later it legalised recreational marijuana. Shortly after, the state issued the Medical Marijuana Regulation and Safety Act **(MMRSA).**

MMRSA, among other guidelines, regulates and taxes the production, manufacture and sale of marijuana for adult use.

Although cannabis has been legal in some form in California for over 20 years, providers remain nervous about the business and legal risk from lack of legalisation at the federal level.

Paxhia says the fund has even received inquiries from other managers posing as investors: "In reality, they are launching their own fund and trying to figure out who our service providers are."

It is perhaps due to this high demand to know about market participants that other managers will not even discuss operational or legal topics pertaining to their funds.

Sean Stiefel, founder of Navy Capital, running $200m, an early investor in the cannabis space, declined to comment, saying such topics were off limits.

Many service providers interviewed said they were 'sworn to secrecy', or would not comment on those participating in the space. Part of this 'omerta' stems from firms being inundated by potential clients once managers know about their involvement.

Providers then "freak out and kick everybody out", according to one industry participant.

Banking can be a significant roadblock for funds to navigate as US nationally chartered banks will not deal with cannabis funds. This leaves managers pursuing relationships with multi-state and local, regional banks.

Art Zwickel, a partner with Paul Hastings ' corporate department, helps clients structure and organise their funds. "We had one client that initiated discussions with 40 different banks and was rejected by all of them," he explains.

Poseidon's Paxhia says not only is finding banking for the fund difficult, but he has even lost his personal banking and brokerage relationships at one point or another. "Banking is a nightmare," he says.

Legislation and business risk

Under the Obama administration, the Department of Justice, then headed by James Cole as attorney-general, issued the Cole Memorandum, guidance essentially saying the prosecution of marijuana cases was not a top priority.

This boost of confidence in the industry, however, was thrown back into limbo as former attorney-general Jeff Sessions rescinded the guidance in early 2018. This left banking and other institutions vulnerable to potential prosecution.

"Banks are concerned that if the political winds shift and there is a move away from the moratorium on prosecution, that they could be prosecuted for money laundering crimes," notes Paul Hastings' Zwickel. "They're not willing to risk it."

Earlier this month, two crucial bipartisan bills were introduced for legislation, the Secure and Fair Enforcement (SAFE) Banking Act and the Strengthening the Tenth Amendment Through Entrusting States, or STATES Act.

The SAFE Act would "create protections for depository institutions that provide financial services to cannabis-related legitimate businesses and services providers for such businesses, and for other purposes", paving the way for existing and new providers in the space.

Meanwhile, if passed, the STATES Act would make the federal government recognise legalisation of marijuana in states where ballot initiatives or the state legislature has legalised it. Essentially, the STATES Act would prevent the FBI and DoJ from prosecuting state-legal cannabis businesses.

Providers have been left to exercise their own judgement, as well as look toward their industry boards or associations for guidance.

“There is definitely a risk for accountants to engage clients in the cannabis space," says Marni Pankin, partner and CPA in the alternatives arm of New York City accounting firm Marcum.

Marcum began working with its first cannabis fund in 2015 and has several relationships in the industry, as well as a pipeline of interested managers. It not only works with funds but also with operating companies and portfolio companies.

In 2015, the American Institute for Certified Public Accountant s (AI CPA) issued guidance on working with cannabis funds. It gave a green light to accounting firms so long as they followed a "good moral character" when working w it h ca n nab is businesses.

A "good moral character" is left to be defined by the states. But generally, it follows the guidelines set forth in the Cole Memorandum, including:

1. Preventing the distribution of marijuana to minors
2. Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs and cartels
3. Preventing the diversion of sale of marijuana from states where it is legal under state law in some form to other states
4. Preventing state-authorised marijuana activity from being used as a cover or pretext for trafficking of other illegal drugs and other illegal activity

“A state board of accountancy could consider providing services to marijuana-related businesses as grounds to refuse to grant or renew a CPA license based on the failure to satisfy ‘the good moral character’ requirement, or as grounds for disciplinary action,” notes Pankin, although she adds none have taken such measures so far.

In addition, Pankin says her firm carries out extensive due diligence, including background checks, speaking with potential clients’ service providers, including attorneys, banks and admins. They also ask potential clients to provide a thorough analysis of their investments.

Current landscape
Despite the risks, the cannabis industry is proving to be extremely profitable for those already taking advantage of the opportunities.

"Everybody was very nervous when we first started. Then people's eyes started to open when they saw how interesting the investment landscape was and how quickly it was changing," says Steve Hawkins, CEO and president of Horizons ETFs Canada.

Horizons Marijuana Life Sciences Index fund is one of the largest in Canada, with around $1.3bn in AuM. It has returned around 50% since the beginning of the year and about 140% on an annualised basis since inception, as of the end of February.

Despite the initial success of the Horizons ETF, which operates in Canada's federally approved cannabis market, Hawkins says it was very difficult to have service providers on board initially. "It took us a while to convince all of our service providers to support us in this endeavour."

This may be changing. In the US and Canada, providers have begun to take note, with more firms offering their services, trading and/or research. Earlier this year, BTIG is said to have begun working with US managers trading public equities in Canada. Cowen is also active in the space as one of the few US-based investment banks doing cannabis research. Both entities declined to comment on their involvement.

Canadian firm Canaccord Genuity is also said to be looking at a custody solution in the space. And SS&C offers an administration service. Both also declined to comment.

Recently, reports surfaced that Citigroup was also looking to service clients looking for a loan or looking to invest in the cannabis market. Such developments may act as a catalyst for more hedge funds to get involved in the early stages of what many see becoming a large global industry.