

A High-Level Discussion of Arizona's Cannabis Market



East Valley Bar Association
March 18, 2022



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Session Description & Objectives

Despite the many challenges, the Arizona Cannabis market surpassed expectations in 2021. At the end of this session, you will have an increased understanding of:

- Current status of industry
- Current/anticipated trends
- Operational/financial challenges
- Opportunities for the legal/accounting profession

Welcome to the Fifth Wave

- The **First Wave** was the awakening or beginning of decriminalization. This phase is about illicit market participants advocating for therapeutic uses of cannabis
- The **Second Wave** was characterized by the early days of medical adoption above all else.
- The **Third Wave** was marked by the money rush set off by adult-use legalization in 2012 and the “vertically integrated” rush of 2016-2018.
- The **Fourth Wave**, from 2019 to present, can be recognized as the cannabis bubble bursting, with sudden deflations in investor expectations, market saturation and over-competition.
- The **Fifth Wave** can be characterized by the stratification of the industry into large multi state fully integrated operators and boutique players focused on specific points within the overall supply and distribution chain.

Source: BVR Resources; Marijuana Venture magazine, September 2021, by James Williams



U.S. Cannabis Sales

- Research shows that in 2021, Americans purchased \$24.6 billion worth of cannabis products, a 34% increase over 2020. This year the U.S. legal cannabis market is expected to grow by a rate of 18% to \$29.2 billion. Analysts forecast that the following states will experience high growth in cannabis sales in the coming year: Arizona (20%), Florida (38%), Pennsylvania (57%), Illinois (58%), and New Jersey (74%).
- According to the *Whitney Economics U.S. Cannabis Business Conditions Survey*, only 42% of operator respondents report turning a profit from their businesses, while 20% are breaking even, and 37% are not profitable. These results are the same for businesses operating in both mature and immature markets across the U.S. Despite that very real and measurable problem, industry growth is expected to continue.
- The bulk of the cannabis industry is still in the black market. Illicit cannabis sales are estimated to be more than \$100 billion each year. The legal industry is catching up, albeit slowly. By 2026, BDSA predicts the legal U.S. cannabis market will reach \$41 billion in annual sales, roughly the size of the craft beer industry.



Medical Marijuana Program

In December 2010, Arizona voters passed the Arizona Medical Marijuana Act (AMMA), A.R.S. §36-2801 et seq.

The AMMA went into effect on April 14, 2011, making Arizona the fourteenth state to adopt a medical marijuana law.

The AMMA designates the Arizona Department of Health Services (ADHS) as the licensing and issuing authority for the Arizona Medical Marijuana Program.



Medical Marijuana Program

Qualifying Patients:

2/2022	12/2021	12/2020	12/2019	12/2018	12/2017	12/2016	12/2015
244,523	266,850	295,295	219,817	186,002	152,979	114,439	87,733

As of February 2022, 94% of cardholders list chronic pain as qualifying health condition.

As of 8/1/2021, there were a total of 143 establishments, with 124 operating facilities.

As of 2/23/2022, there area total of 22 certified testing labs.



Medical Marijuana Program

	Sales	TPT Collected
January	\$ 16,012,587	\$ 1,339,562
February	57,876,976	4,882,535
March	70,736,473	5,919,062
April	85,216,197	7,116,027
May	67,986,597	5,690,357
June	65,457,451	5,485,102
July	76,730,522	6,388,816
Aug	67,764,792	5,699,336
Sept	64,293,430	5,367,686
Oct	68,837,699	5,748,722
Nov	62,890,469	5,278,966
Dec	54,678,382	4,548,869
Totals	\$ 758,481,575	\$ 63,465,040





Arizona Stats – February 2022

The Arizona Department of Health Services’ (ADHS) latest medical marijuana report reveals that Arizona’s medical marijuana program is growing steadily and continues to be one of the largest medical marijuana markets in America. Arizona’s hemp industry is also one of the largest in the country.

Below is data on the status of the Arizona medical marijuana program.

Medical marijuana patients: 244,523

Largest age range %: 18 to 30 years old (63,063)

Caregivers: 716

Dispensary/Facility agents: 22,841

Lab agents: 229

The counties with the most medical marijuana patients:

Maricopa County: 161,918

Pima County: 33,834

Pinal County: 14,862

Source: Arizona Department of Health Services





U.S. and Arizona Employment

According to the *Leafly Job Report 2022*, the legal cannabis industry added 107,059 new jobs in the U.S. in 2021 compared to 77,300 and 32,700 jobs in 2020 and 2019, respectively.

Arizona ranked eighth (23,333 jobs) out of the top ten states by cannabis-related jobs as of January 2022.

The states that ranked above Arizona, with respect to the number of cannabis jobs, included California (83,607), Colorado (38,337), Michigan (31,152), Illinois (28,992), Massachusetts (27,212), Pennsylvania (26,932, medical only), and Florida (25,895, medical only).





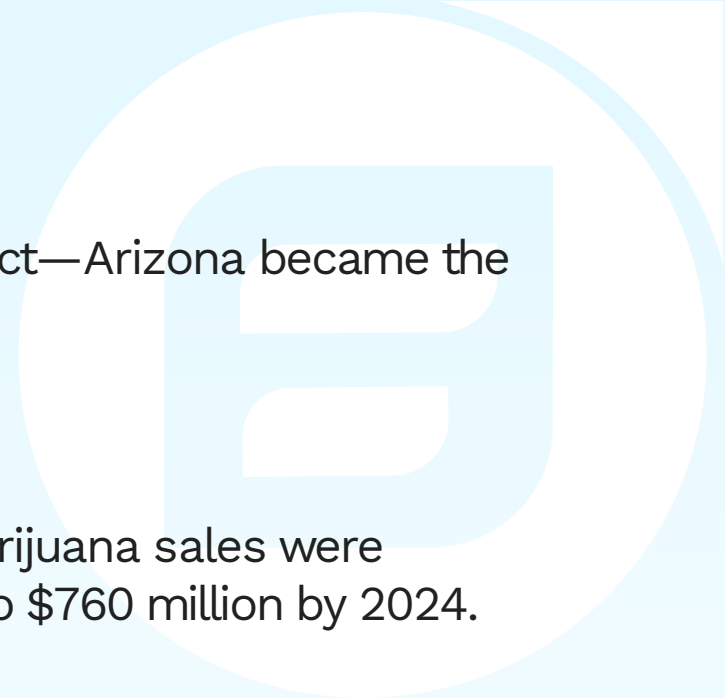
Adult Use

As a result of the passage of Proposition 207—the Smart and Safe Arizona Act—Arizona became the 13th state to legalize recreational marijuana.

Arizona kicked off recreational marijuana sales on January 22, 2021.

According to the *Marijuana Business Daily*, Arizona’s estimated adult-use marijuana sales were expected to reach \$400 million in 2021 (we reached \$594 million) and grow to \$760 million by 2024.

Arizona is expected to issue 26 more licenses under the social equity program. Lottery is expected to occur April 8, 2022.



**Arizona Proposition
207**



Election date
November 3, 2020

Topic
Marijuana

Status
On the ballot

Adult Use

As of June 30, 2021 (last update), there were 143 licenses approved for recreational sales. According to ADOR's Office of Economic Research and Analysis, adult use marijuana taxable sales reported in 2021 were \$594,449,941.

	Sales	TPT Collected	Excise tax collected
January (partial mo.)	\$ 2,904,762	\$ 226,355	\$ 511,520
February	35,761,622	3,042,603	4,574,344
March	48,911,602	4,123,402	7,527,849
April	69,392,007	5,846,576	9,301,292
May	38,240,694	3,275,289	11,010,179
June	52,500,711	4,445,848	10,937,526
July	54,136,123	4,542,166	9,515,016
Aug	50,285,602	4,249,993	9,583,147
Sept	53,476,365	4,512,493	9,222,846
Oct	59,978,873	5,038,213	9,980,570
Nov	62,412,916	5,230,498	10,833,674
Dec	66,448,664	5,536,037	11,139,800
Totals	\$ 594,449,941	\$ 50,069,473	\$ 104,137,763



Testing Law

Starting November 1, 2020, Arizona dispensaries were required to test all medical marijuana via state-approved third-party testing labs before selling to patients.

Anticipated that cost of testing will force dispensaries to increase prices.

Concerns existed that labs were not fully up and running due to COVID.

As of February 24, 2021, there were ten certified testing laboratories in Arizona. Ongoing concerns/challenges have been identified and reported regarding testing failure rates with respect to products containing heavy metals, pesticides, residual solvents and/or microbials, as well as the turnaround time needed to complete testing and the overall regulatory oversight of testing results. One lab (with similar reporting from other cannabis labs in town) recently reported that on 1,758 samples tested, 210 (11.9%) failed for heavy metals, 209 (11.8%) for pesticides, 221 (12.6%) for residual solvents, and 623 (35%) for microbials.



Product Recall

In June 2021, AZDHS issued a voluntary cannabis product recall related to a lab's testing of possible product contamination. According to azcannabisbisnews.com, the lab indicated that the voluntary recall was not the result of any wrongdoing by the products, dispensaries, or brands, but rather an audit-based testing discrepancy between the lab and AZDHS.

In February 2022, Arizona regulators sent notices of intent to revoke the licenses of two marijuana testing laboratories for allegedly using procedures that could inflate product potency results. The two labs disputed the findings but have settled or plan to settle with regulators, the Arizona Republic reported.





Valuation Challenges



- Cash flow forecasting challenges
- Changing regulatory environment
- Extraordinary tax burdens
- Reconciliation of approaches utilized
- Young industry – limited market data
- Preferred approach – Discounted Future Earnings Method
- Build up method/Growth rate consideration
- Access to funding
- Management experience
- Business plan
- Budget analyses
- Assurance/audits
- Limited market data



Fraud Challenges

California businessman gets 2½ years for bank fraud in \$150M pot processing scheme (6/21/21)
<https://www.bankingdive.com/news/california-businessman-gets-212-years-for-bank-fraud-in-150m-pot-processing/602148/>

Buyer Beware — Product Fraud Is Alive And Well In The Cannabis Industry (4/14/2021)
[\(https://thefreshtoast.com/cannabusiness/buyer-beware-product-fraud-is-alive-and-well-in-the-cannabis-industry/\)](https://thefreshtoast.com/cannabusiness/buyer-beware-product-fraud-is-alive-and-well-in-the-cannabis-industry/)

- Synthetic cannabinoid products sold at truck stops
- Vaping crisis
- Labeling laws

America's Pot Labs Have A THC Problem (6/29/2021) (<https://fivethirtyeight.com/features/Americas-pot-labs-have-a-thc-problem/>)

- Lab corruption

Tennessee Titans' Julio Jones sued by cannabis company in connection to alleged fraud, money laundering (7/28/2021) (<https://www.tennessean.com/story/sports/nfl/titans/2021/07/28/tennessee-titans-julio-jones-sued-cannabis-company-alleged-fraud-money-laundering/5397138001/>)

- Suit alleges the defendants illegally managed and operated facility and have failed to report cannabis sales since March 2021





Fraud Challenges

Former California Mayor Arrested on Wire Fraud and Bribery Charges Alleging Illicit Payments for Support of Commercial Cannabis Activity (8/13/2021) (<https://www.cannabisbusinesstimes.com/article/former-california-mayor-arrested-on-cannabis-bribery-charges/>)

- Indictment alleged he accepted more than \$57k in bribes and kickbacks in exchange for approving ordinances authorizing various types of commercial cannabis activity

Marijuana Business Scammers Posing as State Inspectors, Utility Providers (1/20/2021)
(<https://www.westword.com/marijuana/colorado-marijuana-business-scammers-posing-state-inspectors-utility-providers-11884512>)

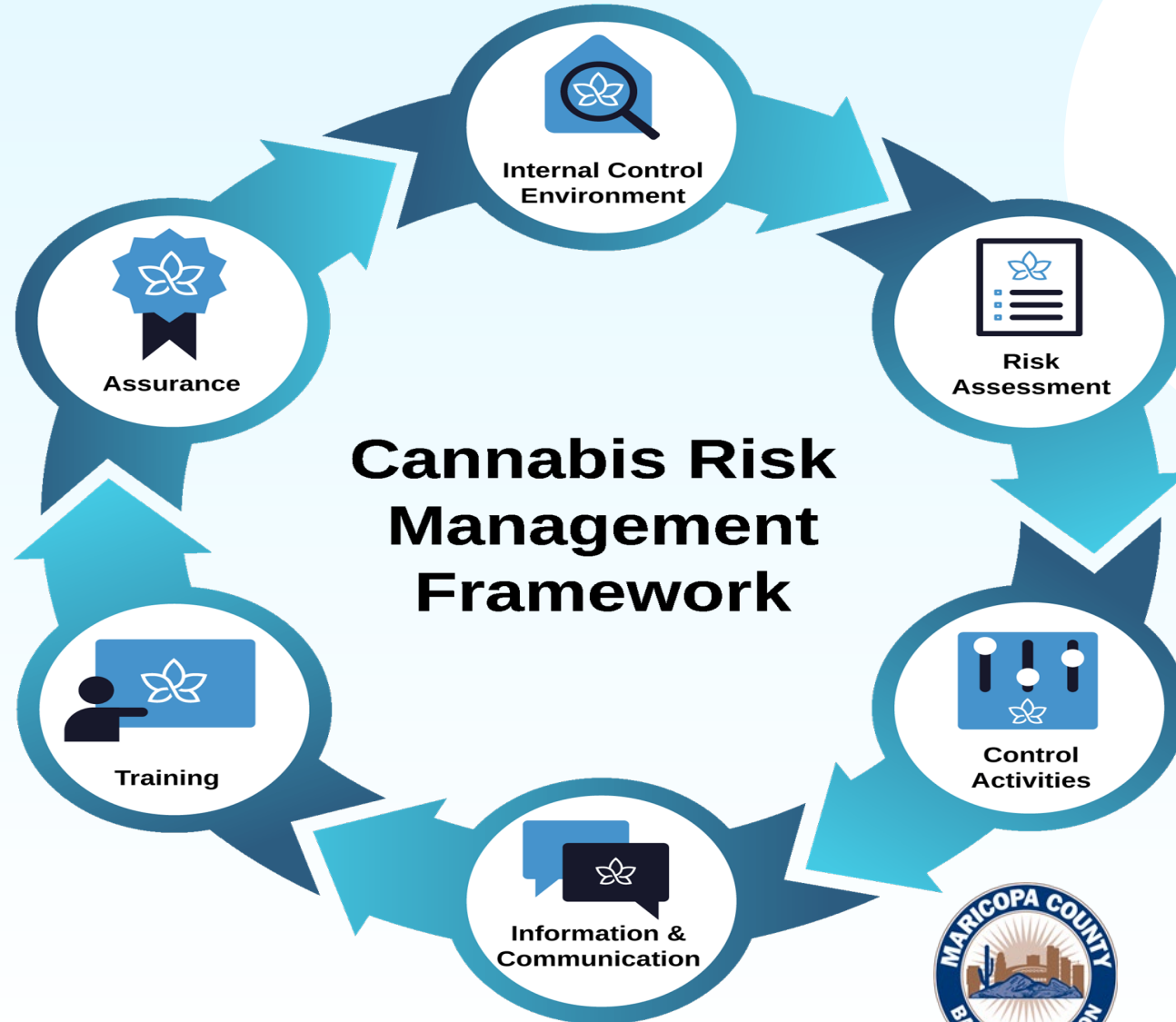


Risk Assessment/Management

- Compliance program
- Internal control environment
- Evaluation of risks
- Record keeping
- Tone from the top
- Communication
- Training
- Vendor management



Risk Assessment/Management



Source: Association of Certified Commercial Cannabis Experts



Tax Issues/Challenges

IRC Section 280E

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on a trade or business if such trade or business (or activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

IRC §280E allows cannabis producers, processors, manufacturers, and retailers to only deduct their cost of goods sold

Financial Impact-IRC §280E

	Other Business	Cannabis Business
Sales	\$3,000,000	\$3,000,000
COGS	<u>(750,000)</u>	<u>(750,000)</u>
Gross Profit	2,250,000	2,250,000
SG&A expenses	<u>(1,250,000)</u>	<u>(1,250,000)</u>
Pre-tax income	1,000,000	1,000,000
Income taxes		
\$1MM x 35%	<u>(350,000)</u>	
\$2,250M x 35%		<u>(787,500)</u>
Net income	\$650,000	\$212,500
Effective tax rate	35%	79%



Best Practices

- Proper record keeping
- Adequate lab testing
- Comprehensive insurance
- Timely payment of taxes
- Proper reporting of cash transactions
- Communication and training
- Periodic risk assessment
- Transparency
- Compliance testing
- Internal control testing



Arizona News

Florida-based cannabis business real estate lender AFC Gamma loaned an additional \$30 million to Arizona-headquartered multistate marijuana operator Devi Holdings, which does business as Nature's Medicines (Source: mjbizdaily.com).

Chicago-based Verano Holdings Corp. announced this month that it closed on its Arizona acquisitions of Territory Dispensary, Emerald Dispensary and Local Joint Dispensary (Source: azmarijuana.com).

Ally Biotech, a provider of leading-edge bioactive delivery solutions for cannabinoids based in Payson, Arizona, announced its patent-pending Lipofusion delivery technology and has entered the Arizona market (Source: azmarijuana.com).

Roop Investments, LLC acquires Arizona's most awarded dual license dispensary in a landmark \$30 million all cash deal. The acquisition awards Roop Investments with The Green Halo's retail operations and its related dispensary, cultivation, and manufacturing licenses (Source: azmarijuana.com).



M&A Activity

In March 2021, Verano Holdings Corp., a multi-state cannabis company, announced it has entered into an agreement to acquire control of Patient Alternative Relief Center, Inc. d/b/a Local Joint, a dispensary in Phoenix, Arizona. The total consideration includes cash consideration of \$13.5 million, with \$10 million payable on the closing date and a \$3.5 million promissory note payable within 120 days after the closing date, and stock consideration of \$3.5 million payable in Class A subordinate voting shares of the company.

In March 2021, Item 9 Labs Corp, a vertically integrated cannabis operator and dispensary franchisor headquartered in Arizona, announced the closing of its acquisition of ONE Cannabis Group, parent company of cannabis dispensary franchise Unity Rd.

In May it was announced that multi-state operator Trulieve is buying Arizona-based Harvest Health in an all-stock deal valued at about \$2.1 billion. According to *MJBiz Canada*, this deal is considered the largest U.S. cannabis transaction to-date.



Banking

Banking institutions are faced with many challenges in the cannabis sector that necessitate dedicated adequate resources to mitigate risk and monitor compliance.

On March 18, 2021, a safe banking bill for 2021 (H.R. 1996) was introduced in the House of Representatives “to provide protections for financial institutions that provide financial services to cannabis-related legitimate businesses and service providers for such businesses, and for other purposes.” The bill sponsors acknowledge that by operating largely in cash, businesses are assuming huge risks making them more susceptible to theft and are more difficult to audit.

While the House has approved the Secure and Fair Enforcement (SAFE) Banking Act five times now in some form, the Senate has failed to advance it under both Republican and Democratic leadership.



Options for Distressed Cannabis Businesses

- Due to federal prohibition against cannabis, cannabis businesses are not eligible for bankruptcy protection (federal court).
- Federal debt relief measures are not available.
- Growing popular option – Court appointed receiverships under state law
 - Not just at the request of the creditors
 - May be initiated by a financially distressed business owner to help avoid bankruptcy (depending on state statute-consult with an attorney) – restructuring process
- Assignment for the Benefit of Creditors – similar to bankruptcy; a state assignee is “charged with the responsibility of gathering all of the Assignor’s assets and selling the Assignor’s right, title and interest in those assets”
- Appointment of a Special Master – Analyze books and records
- Non-judicial workouts





QUESTIONS

Thank you!

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About the Speaker

Josephine Giordano CPA, ABV, CFF, CFE, CBA, ASA, CDBV, CIRA, CICA, CTP, CCCE is the National Cannabis Practice Leader and a Director in the Financial Forensics and Business Valuation Services Group with **BeachFleischman**. She is founder and Chairperson of the Arizona Society of CPA's (ASCPA) Cannabis Special Interest Section. She has authored several articles, including the ASCPA's monthly *Bud Brief*, as well as presented and provided training on cannabis-related topics. She serves as an Education Advisory Board member of the Association of Certified Commercial Cannabis Experts and is a member of the Public Policy Committee of the Arizona Cannabis Chamber of Commerce. She provides tax, audit, financial and operational consulting, risk assessment, business valuation, forensic accounting, turnaround management and litigation support services. Josephine can be reached at jgiordano@beachfleischman.com or 602-792-5981.