TEARSHEET

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With the cannabis market set to double, lenders hope to capitalize on the opportunity

Financing in the space typically has come in the form of equity investments.

Federal deregulation would give more lending options to cannabis businesses.

SHEHZIL ZAHID | **MAY 05, 2021**

With the cannabis market expected to double by 2025, the industry hopes to grow and operate without its hands tied behind its back. One of the biggest challenges is offering cannabis businesses a range of financing options that make sense for their growth.

George Mancheril, CEO of Bespoke Financial, a cannabis lending fintech, says that the cannabis market has grown leaps and bounds in the last 5-10 years, from legalization in a handful of states to 17 in 2021. New York was the most recent state to legalize cannabis at the end of March.

Despite the fact that two-thirds of Americans support the legalization of marijuana, the substance is still federally illegal. Consequently, most financial institutions that are FDIC-insured do not provide lending or banking services to the industry which prevents cannabis businesses from acquiring capital to launch and grow. Consequently, businesses sometimes rely on personal loans and investments.

Matt Hawkins, founder of Entourage Effect Capital, a private investment firm, says the cannabis industry has no real low-cost lines of credit and no working capital lines that most industries have access to. This is where cannabis lenders come in, but Hawkins says that there are few of those to begin with. Most lenders in the space will commonly lend against a company's assets, such as real estate, to act as collateral for the loan. However, private equity investment is the most common type of financing. Since EEC's founding in 2014, the company has made 65 investments in the industry, 90% of which have been through equity or equity-like instruments.

Equity financing has its pros and cons. To begin with, there's no loan to repay, which allows the company to utilize its existing funds in a way that grows the business, and it mitigates any credit issues the company might have. However, sharing control of the business might be a problem for some, especially if there's a difference in vision in growth and management styles — and if too much equity is given up, owners run the risk of losing control of the company.

Pioneer Valley Extracts is a Massachusetts-based cannabis business whose products include vapes, chocolates and gummies. Brother-sister duo Kristen Mara and David Cichocki run the business together, having made a mix of personal and equity investments to grow the business. Cichocki says not a lot of lenders are willing to lend unless the business gives up equity. Since its founding, PV Extracts has given up 20% of its equity in financing. After seeing some of their peers struggle with the net end result, the duo decided to look for alternative financing.

"A lot of companies and a lot of people we know have pretty much gotten to the point where they've given up so much equity that they're a minor stakeholder," says Cichocki. "Being able to access something where you don't have to give up your equity is huge, at least for us."

Finding alternative financing options proved to be a challenge for PV Extracts.

"Trying to find a company to work with that is willing to offer credit lines and things of that nature is very difficult." says Cichocki. "That's where Bespoke came in as a lender willing to offer that to this type of business."

PV Extracts first started borrowing from Bespoke Financial in March 2021. They have a credit line of $200,000 they use to buy inventory in bulk at lower prices, allowing the company to scale its operations to meet demand.

Founded in 2018, Bespoke offers four types of financing that include a line of credit between $100,000 to $10 million; inventory financing that allows borrowers to buy larger quantities of supplies at lower prices; purchase financing where Bespoke advances 100% of the purchase of raw materials; and invoice financing where Bespoke provides businesses with an advance of up to 75% on an accounts receivable invoice.

Bespoke recently closed $8 million in Series A funding, bringing the company's total funding to date to over $28 million. With the $8 million funding, Bespoke plans to expand its fintech capabilities and work on key external data integrations. Mancheril says the goal is to offer faster borrower approval and enhanced risk surveillance. Bespoke hopes to offer real-time financing to the broader network of cannabis ancillary service provider platforms (marketplaces, POS, inventory management platforms, etc.) and their users.

Simmon Saraf, CFO of Satya Capital, an investment firm with cannabis lending experience, says he's surprised fintech has not played a larger role within the cannabis lending industry. Saraf says there's a large, existing repository of industry information that fintechs can utilize — he's talking about Metrc, a state-mandated software platform that tracks the cannabis supply chain from seed to sale. Because every cannabis company is required to report sales to Metrc, Saraf says fintechs and lenders can work together to give lenders broader access to the sales data in Metrc. This would allow them to monitor borrower sales in real-time and make appropriate lending decisions.

Despite the fact that the US legal cannabis market is projected to double to $41.5 billion by 2025, there are a lot of hurdles that prevent the cannabis market from reaching its true potential. Saraf says that in many ways, lending within the cannabis industry is no different than lending to any newly formed company. Many borrowers will have limited operating history and will have newly formed management teams that are still learning how to operate. However, the fact that the majority of cannabis companies have operated or continue to operate predominantly in cash makes fraud among bad-faith players easier. It also makes it harder to maintain transparency with lenders.

Moreover, cannabis is still scheduled as an illicit substance on the federal level, so a lot of loan providers are uncomfortable lending to cannabis businesses until they're legal across the board. On the other hand, Mancheril says some loan providers have morality clauses in their investment guidelines where they can't lend to anything that's vice-related. Although some states have legalized cannabis, the legal framework differs state to state so the regulations are not easily translatable across state lines from a compliance standpoint.

A lack of credit data also prevents the cannabis lending industry from growing more rapidly, with the absence of credit performance track records preventing lenders from evaluating risk and approving borrowers. Despite all these issues, Mancheril maintains that the cannabis industry has nowhere to go but up.

"What's helped the industry set all these record numbers and high growth rates has been the fact that there's this tremendous market and consumer base." says Mancheril. "But at the end of the day, we're still sitting in a situation where the industry is operating with both hands tied behind its back."

Mancheril says the day that the cannabis industry operates without legal impediments may not be too far off. In April 2021, the House of Representatives passed the SAFE Banking Act. The act would prevent federal regulators from punishing financial institutions for providing their services to cannabis companies, their owners and their employees.

Although the act's passage is a step in the right direction, it will still need to pass the Senate and then be signed by President Joe Biden in order to become law.

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