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The Green Rush: The Cannabis Industry Rolls On

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On October 17, 2018, the Canadian recreational cannabis market will open under a patchwork of federal and provincial legislation. With just over two months before legalization, the Canadian cannabis industry continues to evolve and grow at an unprecedented pace.

We highlight significant developments that have occurred in the industry since our last update, The Cannabis Frenzy, in April 2018.

Ontario Goes Private

Under Ontario's prior Liberal government, cannabis was to be sold through the Ontario Cannabis Store, a subsidiary of the Liquor Control Board of Ontario. Although 40 stores were to be opened in 2018, to date, only four locations have been selected. Media reports have speculated that Ontario's new Progressive Conservative government is considering a move towards a private retail distribution model, similar to the Alberta model. Adding to the confusion is the fact that, unlike other provinces, Ontario has not yet announced any supply agreements with licensed producers. With October 17 fast approaching and no formal announcements by the Ontario government, many are left questioning whether the Ontario recreational market will be ready on time.

M&A Update

We continue to see consolidation in the cannabis industry as producers race to gain a competitive advantage in time for October. In July 2018, as a result of the efforts of certain shareholders of MedReleaf Corp. to catalyze the sale of the company, Aurora Cannabis Inc. completed an all-share acquisition of MedReleaf, bringing together two of Canada's largest cannabis companies, in a transaction valued at approximately $3.2 billion. Davies advised the shareholders of MedReleaf on the transaction.

While a key factor driving M&A activity in the cannabis industry has been the desire for increased production capacity, companies have also focused on vertical integration, looking to expand their retail footprints in provinces where distribution will be permitted through private retailers. In February 2018, Aurora acquired a 19.9% ownership interest in Liquor Stores N.A., a Western Canadian liquor store operator with 231 existing retail outlets. Following a similar strategy in July 2018, Canopy Growth announced the acquisition of retail and brand-focused Hiku Brands Ltd. for approximately $250 million. The acquisition is intended to expand Canopy's retail footprint in Alberta, Manitoba and potentially Ontario.

International Expansion

Another M&A trend in 2018 has been the international expansion by Canadian cannabis companies in an attempt to capitalize on the ultimate legalization of cannabis worldwide. In 2018, Canopy Growth expanded into southern Africa, through the acquisition of Daddy Cann Lesotho, and into Latin America through the acquisition of a Colombian cannabis company rebranded as Spectrum Cannabis Colombia. Aphria Inc. also announced plans to expand into Latin America and the Caribbean with the acquisition of industry-leading companies in Colombia, Argentina, Jamaica, and a right of first offer and refusal in respect of Brazil. We expect to continue to see Canadian companies expand into international markets, in particular in jurisdictions with a climate more suitable to the outdoor cultivation of cannabis, with the aim of reducing costs and expanding distribution channels.

Alcohol Companies Enter the Market

Following Constellation Brands' investment in Canopy Growth in 2017, many speculated that other alcohol and brewing companies would pursue similar opportunities. On August 1, 2018, Molson Coors Canada, the Canadian business unit of Colorado-based Molson Coors Brewing Company, announced a joint venture with The Hydropothecary Corporation to develop non-alcoholic, cannabis-infused beverages for the Canadian market. Partnerships of this nature make sense: alcohol and brewing companies have regulatory, consumer branding and commercialization expertise that can assist cannabis companies in bringing innovative products to market. Although cannabis beverages will not initially be legal, we expect to see more of these partnerships being formed as industry participants anticipate a change in the law in 2019 to allow for the sale of beverages, edibles and other derivative cannabis products.

(Some) Banks Take the Leap

While many of the bank-owned dealers continue to sit on the sidelines of the Canadian cannabis industry, BMO Capital Markets and CIBC Capital Markets have entered the field. In 2018, BMO co-led five financings, including most recently the $500-million bond offering of Canopy Growth and the US$-153 million initial public offering of Tilray Inc. BMO also acted as adviser to Aurora in its purchase of MedReLeaf and to Hiku in its sale to Canopy Growth. The Bank of Montreal has also agreed to a $250-million secured loan to Aurora. In July 2018, CIBC Capital Markets co-led a financing for Canopy Rivers, a subsidiary of Canopy Growth, in connection with the reverse takeover by Canopy Rivers of a TSX-Venture (TSXV) listed company. The more reluctant Canadian banks will likely be drawn into the industry as their traditional clients, such as grocery store chains, pharmacies and beverage companies, enter the evolving and growing cannabis market.

U.S. Issuers Come North; Canadian Issuers Go South

U.S.-based cannabis companies operating in states that have legalized cannabis continue to face financing challenges, resulting in several of these companies listing on the Canadian Securities Exchange (CSE). Unlike the Toronto Stock Exchange (TSX) and TSXV, the CSE does not restrict issuers with U.S.-cannabis-related activities from listing and trading on the exchange. To date, there are approximately 18 CSE-listed issuers operating in the U.S. cannabis industry, half of which were listed in 2018. Most notably, in May 2018, MedMen Enterprises Inc., a U.S. cultivator, producer and retailer of cannabis with operations in California, Nevada, Florida and New York, began trading on the CSE. MedMen has a market capitalization of approximately $125 million, making it one of the largest CSE-listed cannabis companies.

Many U.S. investors are still wary of investing in U.S. cannabis companies because cannabis remains a Schedule I narcotic under the federal U.S. *Controlled Substances Act*. This lack of investment opportunity in their own country has caused U.S. investors to seek out investments in Canadian cannabis companies. In response to this high demand, we have seen a trend of Canadian cannabis companies listing on U.S. stock exchanges. In April, Cronos Group became the first Canadian cannabis company to have a cross-listing on the TSXV and the Nasdaq. Shortly thereafter, Canopy Growth, a TSX-listed company, became the first Canadian cannabis company to list on the New York Stock Exchange. More recently, Tilray, a Canadian licensed producer, completed its initial public offering on the Nasdaq without listing on any Canadian exchange. Presumably the choice not to list on a Canadian stock exchange was driven by an expected significant U.S. investor demand.

Federal Regulatory Fees

In July 2018, Health Canada released for consultation a discussion paper on the proposed approach to cost recovery for the regulation of cannabis. The cost-recovery regime is based on the principle that the public should not bear the costs of government activities where private parties derive the primary benefit.

Regulatory fees are proposed to be imposed on licensed cultivators, processors, nurseries and sellers of medical cannabis, including an application screening fee of $3,277 per application, and an annual regulatory fee of 2.3% of cannabis revenue.

These additional costs will be mostly borne by the larger producers and could have an impact on margins or retail prices. These fees are in addition to the excise tax that will be collected by the federal government on retail sales and could affect the producers' ability to compete with the illicit market on pricing.

Brand Differentiation Strategies

The *Cannabis Act* will impose significant constraints on the ability of licensed producers to use traditional marketing techniques to build brand awareness. Plain packaging requirements and prohibitions on product endorsements will limit the ability of producers to differentiate their products.

Many licensed producers have responded to the imminent imposition of the stricter restrictions by attempting to generate brand awareness before the regulatory regime comes into effect. For instance, in March 2018, Canopy Growth sponsored a fashion show during Toronto Men's Fashion Week, featuring designers incorporating the brand's namesake textile into the models' outfits. In June 2018, Aurora sponsored Toronto's North By Northeast music festival, advertising the Aurora brand across festival materials and in key event spaces. Some licensed producers have also modified their strategies in an attempt to satisfy the legislative constraints while still leveraging celebrity associations. Newstrike Resources Ltd. brought the members of the Tragically Hip aboard as investors, while Invictus MD Strategies announced that KISS bassist Gene Simmons had joined the company as an investor and "chief evangelist officer." Licensed producers argue that that these partnerships are not product endorsements since the celebrities focus on promoting company shares as investments, but do not advertise cannabis products themselves.

Security Clearance Requirements for Public Company Shareholders

Under the federal cannabis legislation, security clearances will be required by a wider universe of market participants. Notably, this will include persons able to exercise direct control over a licence holder even if it is a public company. Health Canada's guidance indicates that a holding of more than 50% of the voting interest of a licence holder would be considered direct control. Similarly, if an individual controls a licence holder by holding an "influential amount of voting stock" or through the terms of a partnership agreement, that individual would also be required to hold a security clearance. These requirements may prove to be challenging to navigate for investors looking to acquire control of public cannabis companies by way of a hostile takeover bid.

Reporting Key Investors of Private Companies

Private cannabis companies will be required to provide Health Canada with information regarding their key investors. They must also report annually to the Minister, disclosing (i) how the investor exercises control and details of the transaction by which the investor became such an investor; (ii) details of each instance in which the investor provided money, goods or services to the licence holder, including the amount provided or the fair market value, as applicable, the date of the transaction, the interest rate in the case of a loan and any other applicable terms and conditions; and (iii) details of any benefits received by the key investor.

A "key investor" is a person that exercises, or is in a position to exercise, direct or indirect control over a private licence holder by virtue of

- having provided money, goods or services directly or indirectly to the holder; or
- holding an ownership interest or other right or interest in, or in respect of, a business operated by the licence holder.

Health Canada's guidance indicates that in assessing whether an investor has indirect control, relevant factors include the percentage of ownership interest held, the ownership of a large debt that is payable on demand, the terms of a shareholders agreement, and commercial or contractual relationships such as economic dependence on a single supplier or customer.

Cannabis at Law School

Osgoode Hall Law School is launching a course in cannabis law this fall to introduce students to this vast and growing area of domestic and international commercial law. The course was designed and will be taught by Mindy Gilbert and Patricia Olasker of Davies.

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