Cannabis Production Facilities: A Legislation & Valuation 'Joint' Presentation

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Warning: you may learn something and have fun doing it.

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History of Legalizing Cannabis in Canada

- Legal access to dried marijuana was first provided in 1999, which lead to the implementation of the Marihuana for Medical Access Regulation (MMAR) in 2001.
- In 2013 the Marihuana for Medical Purposes Regulation (MMPR) was enacted.
- August 2016. MMPR was replaced by the Access to Cannabis for Medical Purposes Regulation (ACMPR).
- October 2018, the Cannabis Act was approved by Canadian Parliament and recreational
- October 2019, edible Cannabis products were legalized.

Economics of Cannabis Industry

- Revenues from 2018 to 2021 are estimated at $11 billion
- Capital expenditures for the same period are estimated at $29 billion
- The industry has contributed approximately $43.6 billion to Canada's GDP
- The industry has contributed approximately $15.1 billion in government tax revenue

Source: 2021 Cannabis Annual Report, Deloitte

Property Taxation and the Legislative Treatment of Cultivation Facilities

British Columbia

- October 2018 – legislation changed to exclude Cannabis from farm classification or exemptions, assessed as non-residential / industrial
- Hemp operations still meet farm classification
- Cannabis specific production operations are excluded, should other qualifying farm operations on location exist, a split classification to the parcel and/or asset is permitted for assessment purposes

Alberta

- November 2019 – legislation changed to exclude Cannabis grow operations from farm exemption
  - Effective for 2020 tax year forward
  - Prior to this announcement, buildings housing farming operations were 100% exempt from property assessment and tax in rural jurisdictions. In urban jurisdictions the exemption was on a phased in schedule; 2019 the exemption was 70%, in 2020 the exemption would have been 80%.
  - Farm building exemption phase out complete in 2022, would have made all cannabis production buildings exempt from assessment & tax
- Market value assessment at non-residential tax rates apply, often assessed on cost through Marshall & Swift
- Impact to annual operating expenses is significant and unplanned for early adopters
- There are several assessment categories in Alberta which will be applicable to cannabis production operations. These include land, buildings & structures, machinery & equipment, and linear property; all of which have varying levels of assessment and taxation

Property Taxation and the Legislative Treatment of Cultivation Facilities

Saskatchewan

- All cannabis facilities are classed and assessed as non-residential. Legislation appears to support farming operations but has yet to be challenged

Manitoba

- Another jurisdiction where there is no concrete methodology for assessing cannabis facilities
- Excerpts from legislation:

"**farming**" means commercial crop production and includes tillage of the soil, livestock production, raising poultry, dairy farming, fur farming, tree farming, bee keeping, fish farming, horticultural production, including flowers and shrubs, and any other activity undertaken to produce agricultural products on a commercial basis; and does not include the purchase and resale of agricultural products, or the commercial processing of agricultural products; (« production agricole »)

"**commercial crop**" means agricultural products grown on a commercial basis, and includes wheat, oats, barley, rye, corn and other cereal crops and feed crops, flax, canola, sunflower, mustard, millet, grass and other oil seed and seed crops, alfalfa and other forage crops, root crops, vegetables, pulses and fruit; (« culture commerciale »)

Property Taxation and the Legislative Treatment of Cultivation Facilities

Ontario

- The value of a property for tax purposes that is classified under farm or industrial is based on the value of the land and the building, but not the equipment used in the activities

Quebec

- No definitive legislation is determined yet for cannabis production and its tax classification (which can include commercial, industrial or farm). There are, however, tax credits varying from 30 to 40 per cent applicable to properties classified as farm
- There are no specific rules and each case could be different since no jurisprudence yet. Generally, greenhouses for cannabis are considered farming operations for realty tax purposes while transformation areas with their accessories areas (offices, mechanical, storage) are considered as manufacturing operations, even if both operations are within the same site

Newfoundland

- Generally no farming classifications, an improved facility would be classified as commercial

Nova Scotia

- Depends on zoning but generally classed as non-residential / commercial

New Brunswick

- Mixed between 'residential and non-residential.' Its Service New Brunswick's policy (not legislated) that the growing and drying sections of a cannabis plant is assessed at taxed at the lower residential rate (agricultural use), while the remaining sections are assessed and taxed at the non-residential rate (industrial production).

Split classifications, where there are ancillary activities such as production and packaging is common nationally.

Approaches to Value

- Income Approach
  - Limited market data to infer cap rates and valuation
  - 7 to 10% and in some cases, much higher to account for the added risk.

- Sales Approach
  - Limited transactional data of cannabis cultivation facilities
  - Greenhouse facilities are transacting between $18 and $30 a square foot
  - Industrial cultivation facilities are transacting between $140 and $264

Cost Approach to Value

- Land Value plus depreciated value of improvements
- Depending on the assignment, a value for specialized improvements may be added.
  - For example, grow and clean rooms, additional HVAC and irrigation systems.
  - Build out costs can range from as little as $68 to as much as $350
- Account for all forms of depreciation
  - Age-life, functional and external

External Obsolescence Analysis

- External obsolescence may be caused by economic or locational factors
  - Temporary or permanent
  - Not usually considered curable
- Economic analysis should consider the current and future economic conditions.
  - i.e/ changes in GDP, interest rates, unemployment and inflation rates.

Factors that Contribute to Obsolescence

- Changes in supply and demand
- Building utility
- Changes in the cost of raw materials and inputs
- Government regulations that require capital expenditures that are required but add little or no return

External Obsolescence

- Analysis of market data
- Allocation of market-extracted depreciation
- Utilization Analysis
- Gross Margin Analysis
- Capitalization of an income loss

External Obsolescence – Market Extraction

- Calculates a lump sum figure for depreciation

  Total project cost

  - Less sale price (excluding land value)

  = Equals total depreciation

  - Less all other forms of depreciation and obsolescence

  = Equals external depreciation

- Obsolescence review from this method is on average 75%

Example

Alberta – Aurora Cannabis

- New facility build in Medicine Hat area – 1.7 million square feet
  - Nearly complete with $250 million in cost to buildout facility
  - Pending sale of $47 million dollars
- **Quebec – The Green Organic Dutchman (TGOD)**
- New facility cost approximately $471 million to build a state of the art million plus square foot cultivation and processing facility.
  - Sold to Canna Biotech for $27 million

External Obsolescence - Utilization Analysis

- Is a study in supply and demand
- Understanding a facilities capacity and production outputs
- The typical measure is:
  - 1 - Production/Capacity.
  - 1 – Demand/Supply
- According to Cannabis Statistics the average EO is approximately 24%.

External Obsolescence – Gross Margin

- Is a measure of profitability.
- Gross Margin (GM) is revenue less cost of goods sold
  - Revenues are derived from the sale of cannabis
  - Costs of goods sold are the direct costs associated to the production or cultivation of the plant
- Typical formula:

$$\frac{Benchmark\ GM\% - Current\ GM\%}{Benchmark\ GM\ \%}$$

External Obsolescence – Capitalization of Income Loss

- Where a property produces income, the income loss caused by the external obsolescence can be capitalized
  - One understand the market, and two capitalize the income loss relative to the market.

- When external obsolescence is not expected to be permanent
  - A capitalized discounted cash flow of anticipated earnings may explain current and future obsolescence.

Market Trends

- Market consolidation
- The industry will turn a profit
- Craft Cannabis will continue grow and provide more options to consumers

THANK YOU

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