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The Future Of Cannabis is Interstate Commerce

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Hedgeye Cannabis

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Please submit questions* to
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*Answered at the end of the call

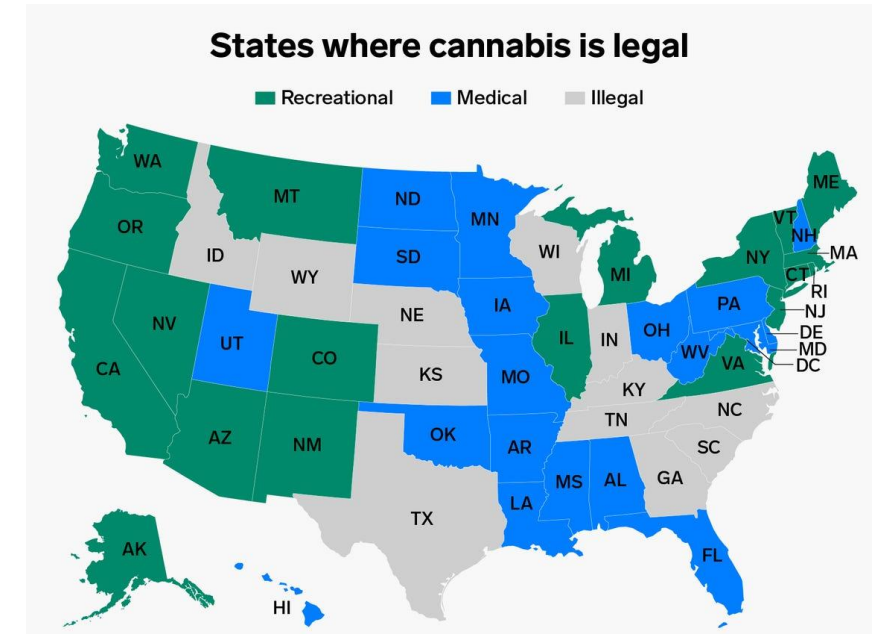
The Future of Cannabis is Interstate Commerce



The Cannabis Dilemma

State-legal Cannabis Industries Operate Today In Direct Violation Of Federal Law Under The Controlled Substances Act.

- Despite those markets operating entirely intra-state, sales in those markets already constitute “interstate commerce” under 80 years of Supreme Court precedent, beginning with *Wickard v. Filburn*, 317 US 111 (1942), and reaffirmed in the context of cannabis specifically in *Gonzales v. Raich*, 545 US 1 (2005).
- “Legal cannabis” therefore operates (in legal, if not political terms) only because the US Department of Justice has indicated that they will not prosecute those acting under state regulation.
- While President Biden has disappointed many by his continued reluctance to embrace federal legalization, his is nevertheless the first administration in US history (President and Attorney General both) to stand firmly and publicly behind state decision making and regulatory authority in cannabis.
- **“The President supports leaving decisions regarding legalization for recreational use up to the states.”** - White House Spokesperson Jen Psaki in her Press Briefing on April 20th, 2021
- **“I do not think it is the best use of the Department’s limited resources to pursue prosecutions of those who are complying with the laws in states that have legalized and are effectively regulating marijuana,”** And: “It’s probably not a good use of our resources where (cannabis) is regulated by the state.” - Attorney General Garland, before the House Appropriations Subcommittee on May 4th.
- Supreme Court Justice Thomas’s 2021 comments in the *Standing Akimbo. Feinberg v. Comm’r* case may show the Court is ready to act. Justice Thomas described the present federal cannabis ban as “half-in, half out,” and went on to state that “A prohibition on intrastate use or cultivation of marijuana may no longer be necessary or proper to support the Federal Government’s piecemeal approach.”



States Take An Active Role Shaping The Industry

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With the democrats have failed to pass any Cannabis legislation at the federal level it once again put upon the states to enact laws that can potentially benefit the industry economically.

- Beginning with California legalizing medical MJ in 1996, the Cannabis industry has always grown by state level initiatives
- The Cole Memorandum set off another wave of growth The Cole memo was a United States Department of Justice memorandum issued August 29, 2013, by United States Deputy Attorney General James M. Cole during the presidency of Barack Obama. The Cole memo stated that given its limited resources, the Justice Department would not enforce federal marijuana prohibition in states that "legalized marijuana in some form and ... implemented strong and effective regulatory and enforcement systems to control the cultivation, distribution, sale, and possession of marijuana."
- Since that time, we have seen a significant number states pass medical and recreational laws. Since then, the medical use of cannabis has been legalized in 39 states and the District of Columbia. The recreational or adult-use of cannabis is also legal in DC and 19 states.
- Federal legalization of cannabis may not happen for 5-10 years.
- In 2022, the Governor of California has passed several laws that are aimed to fix the failing industry. Governor Gavin Newsom on 09/17/22 signed several measures that he says will strengthen the state's cannabis laws, expand the legal cannabis market, and "redress the harms of cannabis prohibition."
- **California is leading the way with a new Interstate commerce law. Newsome signed Senate Bill 1326, which creates a process for California to enter into agreements with other states to allow cannabis transactions with entities outside of California. He also signed several other laws to benefit the California cannabis industry.**

Next Big Cannabis Movement Lead By States

Interstate Commerce Will Be The Next Big State Lead With Federal Implications.

Oregon's Past A First In The Nation 2019 Interstate Bill – Senate Bill 582.

- The Oregon law contained a trigger provision, requiring that before the state can execute such an agreement the federal government must either give permission for such commerce via statute, or indicate tolerance through a Department of Justice memo or policy statement.
- The new California Interstate commerce bill requires Governor Newsom to seek permission from US AG for guidance on interstate commerce agreements.
- A state the size of California is a significant step toward Cannabis Interstate Commerce that will align “production” states with “consumption” states.
- The “producing” states, essentially places where high quality cannabis can be grown outdoors (Oregon and California) together are estimated to have produced close to 90% of the nation’s domestically grown cannabis
- Currently thousands of small producers in those states face economic catastrophe or have already failed. Many of these communities have depended on the economics of cannabis long before legalization and have been at the center of War On drugs.



Its Basic Economics

Cannabis businesses that are “state siloed” are economically inefficient.

- The industry is divided into “producing states” and “consumption” states. For example, California and Oregon are producing states, while New York and New Jersey are examples of consumption states. Cannabis can not be grown efficiently or sustainably in all parts of the country.
- The US MSO have spent millions of dollars replicating their entire production infrastructure in each state, rather than scaling up production and using one facility as a central distribution point for retailers across the country.
- Cultivation capacity takes can take years to come fully online and is complex to run. Often many companies' earnings and margins may be impacted by the inefficiencies. That said vertical integration is an important part of the investment case for Tier 1 companies.
- Why if it's made in California it needs to stay in California or if it's grown in New Jersey, then it needs to be consumed in New Jersey? (For example, Citrus is grown in Florida and Corn in Iowa)
- Cannabis retailers in one state must only purchase products from cultivators and producers in that state, regardless of whether there is consumer demand for out-of-state products or if wholesale prices are cheaper across state lines.
- This means that many legal and legalizing states are stuck building entire production supply chains that will largely become non-competitive when the walls do finally come down.
- None of this reflects the actual future of a Federally legal market.

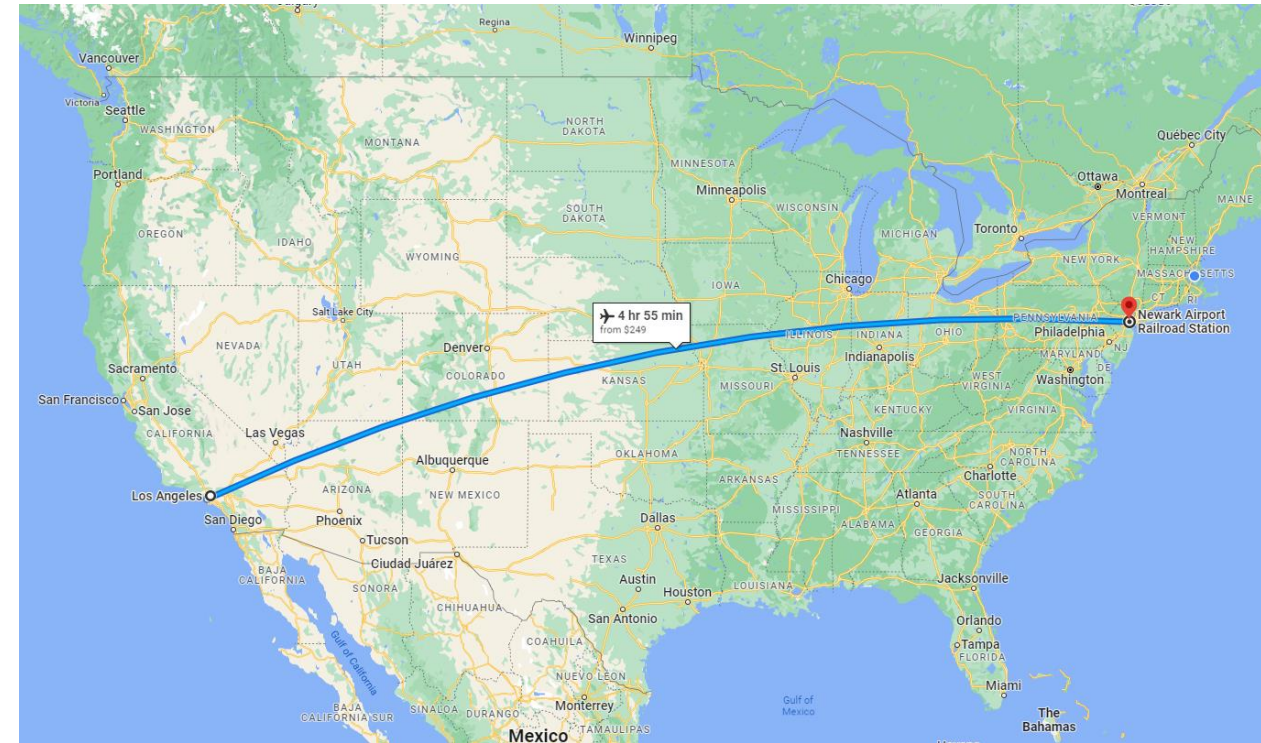
What will likely be a proof of concept?

Improving the economics of “Producing” States and “Consuming” States

- In late August, New Jersey Senate President Nick Scutari - who was the champion of his state's successful adult-use legalization bill - introduced an interstate commerce bill nearly identical to California's, making them the first "consumer state" to move seriously toward opening its market.
- The governor of New Jersey would be authorized to enter into agreements for interstate marijuana commerce with other states that have legalized cannabis under the bill filed by Senate President Nicholas Scutari (D).
- The fact that the bill is being sponsored by the Senate president—who also championed the state’s legalization law—signals that this is a serious legislative endeavor.
- With several adult-use marijuana markets in the Northeast region experiencing supply shortages, interstate commerce will reduce the capital needed to grow industry sales.
- The NJ bill is proposing to create the policy infrastructure for interstate cannabis commerce that could significantly expand the currently fragmented industry
- Agreements could involve either medical or adult-use marijuana products, so potential possibilities is theoretically expansive
- Utah has indicated they would like to legalize, but don’t want cultivation.
- Nevada can benefit from California Cannabis and it’s a border state
- CONGRESS TAKES A SWING AT INTERSTATE TRADE — A newly introduced bill would allow small farmers and producers to ship cannabis straight to consumers — and across state lines. The bill, which is cosponsored by Reps. Jared Huffman (D-Calif.) and Earl Blumenauer (D-Ore.) have practically no chance of passing in the last four months of Congress, but it is a novel approach to the age-old problem of siloed markets.

Some Benefits Of Interstate Commerce

- There are also regulatory requirements that must be agreed upon by each of the participating states. The New Jersey Cannabis Regulatory Commission (CRC) and the legislature's Joint Budget Oversight Committee would have certain oversight and rulemaking responsibilities to that end. In addition, interstate marijuana commerce agreements would be contingent on compliance with the contracting state's cannabis laws, including those pertaining to licensure.
- The states must agree on the mode of transportation for marijuana products to be exported and imported – Air and Rail are federally regulated
- Thousands of small and equity businesses in newly legal/medical states could get up and running sooner and more competitively
- Create a more economically sustainable and diverse supply chain.



Industry Implications Of Interstate Commerce

- A codified Cole Memorandum in writing by Attorney General Merrick Garland would be a significant positive for the industry. The possibility may include other provisions to allow for Banking provisions and Up listing. The timeline for implementation even if it is passed is uncertain because Congress or the Justice Department gives such activity the green light.
- Allow for new investment, expansion, and business formation, creating tens of thousands of jobs and generating billions in economic activity in local communities.
- Ensure that retailers in emerging markets can meet local demand for the highest quality medical and recreational products
- Processors and manufacturers have reliable access to sustainably and economically produced bulk materials.
- Unlock opportunities for social equity participants in legalized states. Many of these program's cant get off the ground due to the lack of supply and significant cost relative to imported products.
- Prepare for full legalization by developing a regulatory framework based on sound economic principles and common sense.
- Will eliminate the need for redundant cultivation capacity in “consuming states.”
- Lowering COGS and capital spending to build capacity in new Recreational states (i.e. NJ, NY & CT) will allow for faster growth in those markets.
- Interstate Commerce is enviable; thus, a gradual rollout is beneficial to all parties. Many states will wait until federal legalization (i.e., FL & IL)
- Will be a boom for companies like Glass House (GLASF). GLASF is producing Sun grown Cannabis at \$120/LB (\$0.26/gram) in California versus an estimate of \$500/LB (\$1.10/gram) for MOS in “producing states ”
- GLASF can cut COGS by 50% for operators in consuming states and produce a 45-50% gross margin.