

#### IN THIS CHAPTER

- » Deciding whether you really want to invest in cannabis
- » Looking at businesses that have contact with the plant versus those that don't
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## Chapter **1**

# Taking the Nickel Tour of Cannabis Investing

**W**henever you're getting started on a new topic or trying to develop a new skill, you can benefit from having a general understanding of what's involved. It's sort of like reading the plot or synopsis of a movie or book before starting to watch or read it, or seeing the finished product before you start following the instructions to assemble it. You get the gist of what you're about to encounter, which serves as both a framework on which you can hang the details, and the context for more quickly and easily understanding those details. The purpose of this chapter is to bring you quickly up to speed on the topic of investing in cannabis.

# Weighing the Pros and Cons of Investing in Cannabis

The following sections present some of the most important pros and cons you should consider and leave the decision up to you.

## Pros

The biggest motive people have for investing their money in any venture is profit. Chances are good that you, too, are curious about investing in cannabis because you want to profit from it. The industry is growing in leaps and bounds, and you want in on the action. Nothing wrong with that, but consider other benefits. Here's a list:

- » Profit (which is already mentioned) is the biggie.
- » Getting in at or near the bottom of a new and exciting industry is always a thrill. By investing in cannabis, you become a participant, not merely an observer, in the green rush.
- » Being able to tell people you know that your investment portfolio or retirement account includes cannabis stock. This may sound silly, but being invested in cannabis says something about who you are and may help you engage in conversations you would otherwise be excluded from.
- » If you consume marijuana, you get to invest in a product you enjoy and help to make it more available to others.
- » If you invest in medical marijuana, you're investing in medical research and helping to bring those new medicines to market, potentially alleviating some of the world's physical and perhaps even mental suffering.



REMEMBER

Life offers few choices to invest in a new industry in its infancy. You can think of investing in cannabis as what it would have been like to invest in alcohol three to five years before prohibition was repealed. How often do you get to participate in an industry at the dawn of legalization? Investing in cannabis also may remind you what investing in the dot-com era was like. Cannabis is a new industry. It presents an opportunity for an investor to be a pioneer.

## Cons

There are actually more reasons *not* to invest in cannabis than *to* invest in it. Here's a list of reasons not to invest in cannabis that you should seriously consider before investing in this industry:



WARNING

- » Cannabis attracts money, and money attracts thieves. In addition, many novices eager to invest in cannabis are easy marks because they're eager, naïve, and have money — just the combination of traits a con artist is looking for.

Many of the successful entrepreneurs in cannabis got their start in the black market, which attracts a very particular personality type. Leopards don't change their spots. Some savvy former black marketers have simply chosen a different crime — instead of dealing in illegal marijuana, they're now on the prowl for unsuspecting investors they can fleece. And they're not the only thieves that pose a threat to cannabis investors, as illustrated in the sidebar "Crooks in law enforcement."

- » With lots of money flowing into the industry from eager investors, even legitimate cannabis stocks are overvalued. The more overvalued a stock is, the further the potential fall. Short sellers often target overvalued stocks just for this reason; then, when the stock price drops, they cash in and everyone else loses. (See Book 3 for an introduction to stock investing.)
- » Cannabis businesses struggle to be profitable due to numerous factors, including the high costs of complying with federal, state, and local marijuana laws; increased security costs; increased bank fees; and the cost of specialized software.
- » Cannabis stocks have an increased susceptibility to *dilution* because cannabis companies have a tougher time getting bank loans in the United States (due to federal laws that discourage banks from doing business with cannabis companies). Companies issue and sell more shares to raise money, but that dilutes the value of existing shares.
- » Companies that grow cannabis are at risk of cannabis becoming a commodity, and if (when) that happens, prices and profits drop.
- » Laws, and enforcement of those laws, are susceptible to change, and if they change in a direction that hurts cannabis businesses, their investors suffer as well.
- » Supply-and-demand imbalances are common in the cannabis industry. These imbalances not only disrupt the supply chain but also negatively impact profits by creating market gluts (which drive down prices) or shortages (which increase costs and reduce demand); either way, profits suffer.
- » Cannabis still has a healthy black market, even in states where it's legal, and black-market growers and dealers don't pay taxes, so they can afford to sell their product for less. If state and local authorities don't crack down on illegal production and sales, legal businesses have a tough time competing.

## CROOKS IN LAW ENFORCEMENT

Corrupt law enforcement officers pose a threat to both legitimate cannabis operations and their investors. These bad cops have been known to raid lawfully operating cannabis operations and take cash and product. Operators have little recourse. What are they going to do, call the cops? Likewise, operators get little sympathy and support at the judicial level.

An unjustified raid can be fatal to a business. One dispensary in Los Angeles was raided by the police. They took cash and damaged the on-site cultivation facility, causing hundreds of thousands of dollars in losses, not to mention the loss of revenue that occurred as a result of the closure of the business. It took months to recover from the raid, and the city eventually dropped the charges.

Incidents like that still happen and likely will until federal prohibition of marijuana is repealed.



REMEMBER

Don't rule out investing in cannabis just because of this long list of potential drawbacks. You can considerably reduce your exposure to risk by doing your homework and investing in well-run companies.

## Investing in Businesses That Touch the Plant or Those That Don't

One of the first decisions to make before investing in cannabis is whether to invest in businesses that have contact with the plant or those that don't (often referred to as *ancillary* companies):

» **Plant-touching:** These businesses come into contact with the plant at some point during the growth, manufacturing, distribution, or sale. They include grow operations, manufacturers of infused products (MIPs), shipping firms, dispensaries, and licensed delivery services. Plant-touching businesses stand to profit most from cannabis, and they're also at the greatest risk of suffering losses when the industry takes a hit.



TIP

If you decide to invest in a plant-touching business, consider a *vertically integrated company*, which means the business does its own cultivation, manufacturing, distribution, and sales. Vertically integrated companies are less susceptible to supply chain disruptions because they control their entire supply chain.

» **Ancillary:** These businesses serve the plant-touching businesses in some way. Perhaps the best-known ancillary business is The Scotts Company, which provides fertilizer, pesticides, and disease control products, primarily for lawn care but also for agricultural operations, including cannabis cultivation companies. Other ancillary companies include manufacturers and dealers of equipment for cultivation operations; legal and accounting services that specialize in cannabis; software companies that develop point-of-sale and supply-chain managements systems; security equipment and service providers; and real estate groups that buy, sell, and rent land and buildings for cannabis businesses.

While plant-touching businesses carry the most potential for profit and risk, ancillary companies still stand to profit from the industry, but they have less exposure to risk. For example, if the U.S. federal government decided to crack down on cannabis businesses across the country, that revenue stream would be negatively impacted for The Scotts Company, but the company would still have value as a business selling lawn care products.



REMEMBER

According to a study published by Deloitte in 2016, ancillary businesses are estimated to be 2.5 times the size of the cannabis industry itself, so ancillary businesses stand to profit handsomely from the success of the cannabis industry.

## Exploring Your Investment Options

You can profit from legal cannabis businesses in several ways, depending on how directly you want to be involved. The most direct approach is to start your own cannabis business. The least direct approach is to trade cannabis-related securities, such as stocks, bonds, or exchange-traded funds (ETFs).

The following sections present different ways to invest in the cannabis industry to make you aware of the wide variety of options.

### Starting your own business

One approach to investing in the cannabis industry is to start your own business — either a plant-touching or an ancillary business. Here are some of the more popular opportunities cannabis entrepreneurs pursue.

» **Cultivator:** Cultivators start and grow plants from seeds; harvest the plants; separate the usable portion of the plants and properly dispose of the green waste; dry, cure, and trim the harvested bud; arrange for third-party lab tests



TIP

to ensure the safety and quality of the product; pack and ship product to manufacturers and dispensaries; and track and report all processes as required by law to government regulatory agencies. Note that cultivation operations are the lowest profit-margin segment of the industry.

Cultivation is a great choice if you have a passion for the plant and a green thumb.

- » **Manufacturer of infused products:** MIP is an industry term used to describe a company that makes marijuana-infused products, including concentrates such as wax and shatter; oils and tinctures; and lotions and edibles. This segment of the industry acts as a laboratory as well as a processing plant. It may be even more tightly regulated than other segments of the industry, with additional rules and regulations that extend to manufacturing and commercial kitchens.



TIP

MIP is a great choice for those who want to get more into the science of extracting active ingredients from the plant and using those extracts to create a wide variety of consumer products.

- » **Processed product brand:** A processed product brand could be an MIP or a combined grow/MIP business that makes products and sells them to numerous retail outlets. For example, you could set up your own grow/MIP business to produce a line of infused chocolates that you sell to a variety of medical and recreational dispensaries in Oregon. Another option is to create your own brand and develop unique products and then farm out the growing, manufacturing, and distribution operations to other businesses that specialize in those areas.
- » **Retailer/dispensary owner:** Cannabis retailers run the dispensaries and other retail outlets that sell products directly to consumers. Depending on the rules and regulations in your area, you may be permitted to run a medical dispensary, an adult recreational dispensary, or a dispensary that serves both medical and adult recreational clients. This is like owning a liquor store but with more rules and regulations to follow.
- » **Ancillary business:** Ancillary businesses you may want to consider include the following:
  - Nursery owner
  - Manufacturer or seller of grow lights
  - Heating, ventilation, and air conditioning (HVAC) service provider specializing in ventilation and circulation for grow operations
  - Packaging and labeling manufacturer/supplier
  - Security service, or manufacturer or supplier of security systems and equipment

- Marketing, public relations, or advertising specialist
- Real estate sales, rentals, or management (for more details, see the next section)
- Legal, accounting, or consulting service provider
- Banking and cash management services



WARNING

If you're interested in starting a business that comes in contact with the cannabis plant in any way, don't go it alone, and do be prepared for a high cost of doing business. Especially be sure to consult with a lawyer who has knowledge and expertise in helping businesses comply with state cannabis laws.

## Investing in cannabis real estate

An often overlooked way to invest in cannabis is to buy land zoned for cannabis businesses or to buy land and have it zoned for such businesses and then sell or lease the land to cannabis businesses. You can even erect buildings on the land (or buy land with buildings suitable for certain types of businesses) and sell or lease the commercially improved land to businesses.

If you've seen the movie *The Founder*, about Ray Kroc, the founder of McDonald's, you probably remember his lawyer/advisor telling him, "You don't seem to realize what business you're in. You're not in the burger business; you're in the real estate business. You build an empire by owning the land." Kroc followed that advice and made a fortune buying the land on which McDonald's franchises were built and then leasing that land to the franchise owners.



REMEMBER

You can take a similar approach to profit off the cannabis industry. However, you really need to know not only the cannabis industry and the real estate market, but also the rules and regulations in place that govern where (and what type of) cannabis businesses can be conducted on differently zoned plots of land.

## Buying and selling stocks

The most common way people invest in cannabis is to buy and sell stock in privately or publicly owned cannabis companies. Stocks provide you with a share of the company without your having to get your hands dirty or deal with the complex legal and regulatory issues (and other matters) of starting and running your own cannabis business. Of course, buying shares in an existing business leaves you with less control over the business, leaving the value of your shares in the hands of others. If they're innovative, intelligent, and manage the company effectively, your shares are likely to increase in value, but if they drop the ball, you're likely to lose money on your investment.



REMEMBER

Investing in publicly traded companies has a couple of advantages:

- » **Data availability:** To list their stocks on public stock exchanges, companies must be a certain size and comply with stringent financial reporting standards, which provides a greater level of transparency for investors. In other words, you have more data on which you can base your investment decisions.
- » **Liquidity:** Stock in publicly traded companies is a very liquid investment. You can convert your shares to cash almost immediately by listing them for sale on the exchange, assuming, of course, that someone's willing to buy the shares at a price you're willing to sell them for.

For an introduction to stock investing, see Book 3.



REMEMBER

This book assumes you're investing in cannabis by buying and selling securities (stocks or bonds) in public or private companies and not by starting your own cannabis business or investing in real estate, which may be the focus of other books on investing in real estate. The goal here is to provide the information and guidance you need to research businesses and their management teams to determine whether they're likely to be profitable and good investments for you. You can then decide whether to invest in the company.

## Diversifying with exchange-traded funds and mutual funds

Most financial advisors recommend *diversification* as a way to reduce an investor's exposure to risk. A diversified investment portfolio contains both *stocks* (shares of ownership in a company) and *bonds* (like IOUs, short for "I owe you"); investments in numerous companies in a particular industry; and investments in various industries, such as cannabis, automobiles, pharmaceuticals, and energy.

One quick and easy way to diversify is to purchase shares of an exchange-traded fund (ETF) or mutual fund, both of which contain investments in a variety of businesses. The basic difference between the two is that shares of an ETF can be traded throughout the day like shares of stock, whereas shares of a mutual fund can be traded only after the markets close or before they open, because the share value is calculated a couple of hours after the markets close. You can find several cannabis-specific ETFs to invest in. Cannabis mutual funds are a rarer species. Check out Book 5 for a primer on mutual funds and ETFs.



WARNING

The main drawback of cannabis ETFs and mutual funds is that a fund manager chooses the businesses to invest in, and fund managers may not be experts in the cannabis industry, so they may not make the best choices. You're generally better off doing your own research and making your own choices.

## Considering private investment opportunities

Investing in private companies (in contrast to publicly traded companies) carries significantly more risk but has more potential for a higher return on investment (ROI). You basically have four options for investing in private companies depending on the business's stage of development.

- » **Angel investing:** If you know someone who wants to start a cannabis business, you can bankroll the operation as an *angel investor*, usually in exchange for *ownership equity* (shares of stock) in the company or *convertible debt* (a loan that can later be converted to ownership equity). You can also join a group of angel investors, pooling your money to finance startup businesses.
- » **Venture capital investing:** One step up from angel investing is venture capital investing, which involves providing capital and expertise to take a promising startup to the next level. As with angel investing, you can join venture capital groups to pool money and expertise.
- » **Mezzanine investing:** One step up from venture capital investing is mezzanine investing, which involves private financing in the form of debt or preferred stock. (*Preferred stock* is a higher class of ownership than that provided by common stock. With preferred stock, you have first claim on any assets and earnings if the company struggles or folds.)
- » **Private equity:** Private equity is financing that doesn't appear on public exchanges. It usually comes from funds and investors that invest directly in companies or that engage in buyouts of public companies, which results in those companies being delisted.



REMEMBER

Private investing is usually the realm of high-net-worth individuals — and a perfect example of how the rich get richer.

## Finding Investment Opportunities

Before you can invest in a cannabis business, you need to find a business to invest in. Sure, you can Google “cannabis companies to invest in” or head to an online discount brokerage such as Firsttrade, Ally Invest, or E\*TRADE, and use their tools to track down cannabis companies and ETFs, but those searches are likely to turn up only the biggest, publicly traded cannabis companies. (And a Google search

would be likely to turn up some of the biggest scams.) To get quality leads on cannabis businesses, you have a few options, including the following:



WARNING

» **Word of mouth:** People talk, especially when they're planning something big like starting their own cannabis business. You may hear something from a friend, relative, or casual acquaintance about someone who's interested in starting a cannabis business and is looking for investors.

Be especially careful in your research of word-of-mouth leads, especially if someone approaches you out of the blue about a great investment opportunity.

» **Online resources:** Dozens of general and cannabis-specific investment websites are available to keep investors informed of opportunities. General sites include Yahoo! Finance ([finance.yahoo.com](http://finance.yahoo.com)) and Morningstar ([www.morningstar.com](http://www.morningstar.com)). Cannabis-specific resources include The Marijuana Index ([marijuanaindex.com](http://marijuanaindex.com)), Marijuana Stocks ([marijuanastocks.com](http://marijuanastocks.com)), and Cannabis Stock Trades ([www.cannabisstocktrades.com](http://www.cannabisstocktrades.com)).

» **Apps:** Several smartphone apps are available, including Investing in Weed Stocks, Marijuana Handbook, and Scutify. Search your smartphone's app store for cannabis or marijuana investment apps.

» **Cannabis industry news:** You can find more sources for cannabis industry news than you have time to read. If you have time for only one, check out Marijuana Business Daily ([mjbizdaily.com](http://mjbizdaily.com)). Even if you don't use these sources to find leads on investment opportunities, they're valuable for getting up to speed on the industry and gaining the knowledge you need to make better-informed investment decisions.

» **ETF sites:** If you're interested specifically in cannabis ETFs, check out [ETFdb.com](http://ETFdb.com).

» **Private investment groups:** If you're a high-net-worth individual, consider joining a group of private investors who focus on the cannabis industry. When choosing a group, decide where you want to enter the picture with new businesses — as an angel investor, venture capitalist, mezzanine investor, or member of a private equity firm. Then, look for a reputable group that fits with your investment strategy.

» **A broker:** Many investors are drawn to online discount brokers because of the cheap (or free) trades, but paying extra for a broker who knows the cannabis industry may be the best long-term investment you'll ever make.

# Researching Investment Opportunities

You just got a lead on a new cannabis company looking for investors. Now what? First things first — watch your wallet. Don't invest any money until you thoroughly research the “opportunity.” Your research should include the following:

- » A background check of all owners, managers, and operators. Hire a reputable private investigator to conduct the background checks, and make sure everyone on the team has experience in the industry.
- » An online search for the business and its owners, managers, and operators. Conduct a general Google search and check out some cannabis industry-specific news sites, such as [mjbizdaily.com](http://mjbizdaily.com) and [www.cannabisbusinesstimes.com](http://www.cannabisbusinesstimes.com) to find out more about the people starting and running the business.
- » An evaluation of the company's financial health, to ensure that it has the capital required to operate until it begins to turn a profit.
- » Verification of the business's license to operate in the state or states in which it plans to operate.
- » A careful evaluation of the business plan or business strategy to ensure that the owners and managers have a solid plan in place to turn a profit.
- » An evaluation of the company's competitive position relative to other companies in its space.
- » An evaluation of the company's existing *warrants* and *convertible securities* — essentially contracts with existing investors regarding their current or future equity ownership in the company. You want to know how ownership in the company by current investors could impact your equity ownership in the company and the share price.
- » A check with other investors and reputable analysts with expertise in the cannabis industry to find out whether they know anything about the company or its owners/managers/operators.
- » A conversation with the CEO or other leaders in the business to hear directly from them about their vision and plan for success.
- » A check with a reputable broker in Canada or the United States to verify that the prospect is real, compliant, and listed on a credible exchange. This is necessary only for publicly traded companies.
- » A conversation with your lawyer and your financial advisor to get their opinions about investing in the company. (In other words, get a second and third opinion.)

Additionally, if the business you're thinking of investing in is involved in cultivating cannabis, research the grow master (the person in charge of setting up and managing the operation), the grower's *cost per gram* (average cost to grow one gram of product) compared to competitors' cost per gram, and the cultivator's clientele (to be sure the cultivation operation has reliable customers).



REMEMBER

Bet with your head, not with your heart. Three big market movers are greed, fear of loss (FOL), and fear of missing out (FOMO). Regardless of what you choose to invest in, make rational, data-based decisions.

## Planning Your Investment Strategy

Prior to investing, give some thought to your investment strategy. Common investment strategies for any industry you choose to invest in include the following:

- » **Value investing:** This strategy involves buying stocks in *undervalued companies* — companies that appear, based on their fundamentals, to be worth more than their share price indicates. Value investors believe that the markets are driven, to a large part, by emotion, and that by investing in profitable companies, they'll do better in the long run.
- » **Growth investing:** This strategy involves investing in small companies you think have the potential to increase their earnings faster than their competitors or other companies in the industry. Unlike value investors, growth investors may be willing to pay more than “book value” for shares in the company. (*Book value* is the total amount a company would be worth if it sold all its assets and paid back all its liabilities.)
- » **Momentum investing:** This strategy involves following trends in the prices of securities to capitalize on a company as its share price is rising or to short-sell shares as the share price drops. (To sell short, you borrow a stock and sell it. When the price drops, you buy back the stock and return it to the lender. The difference between the sell price and the buy price is your profit.)
- » **Income investing:** This strategy focuses on earning a steady income from investments. It usually involves buying shares in companies that pay dividends, and buying bonds, which pay out interest on a consistent basis. Income investing is generally safer than value, growth, and momentum investment strategies, but the potential return may be lower.
- » **Investing in what you know:** Many investors buy shares in only the companies they know or the companies that provide the products and services they like, believing that those products and services will likely become increasingly popular among consumers, thereby driving the company's success.

For example, if you're an Amazon Prime member, you may think to yourself, "Wow, Amazon is great. This company really has the potential to make it big," and, based solely on your personal experience, you decide to invest in Amazon.

- » **Dollar cost averaging:** With dollar cost averaging, you buy shares regularly (for example, the same day each month) whether the share price is high or low, so you're not overpaying for a large quantity of shares at any one time. Of course, with this strategy, you're not getting a large quantity of shares at a low price, either.
- » **Diversification:** This strategy involves spreading your investment dollars across a number of industries or a number of companies in the same industry to reduce your exposure to risk if one particular industry or company you invest in goes south.

In the context of cannabis investing, other strategies may include the following:

- » Investing in ancillary businesses that serve the cannabis industry but don't touch the plant. Regardless of which cannabis businesses win or lose, ancillary businesses increase their earnings as the industry as a whole grows.
- » Investing only in vertically integrated companies, which control their entire supply line. These companies also tend to be larger than those that are not vertically integrated.
- » Investing exclusively in medical cannabis or exclusively in adult recreational cannabis, or investing a specific percentage in each.
- » Investing in strong brands that have a presence in multiple states and perhaps even multiple countries.
- » Investing in foreign markets such as Canada, Uruguay, and the European Union.

## Investing in a Cannabis Business

Businesses have two options for raising capital to get started or to grow.

- » **Debt:** They may borrow money from a bank or issue bonds, which are sort of like IOUs, promising to pay back the debt with interest.
- » **Equity:** They may issue stock — selling shares in the business.

As a result, you have two ways to invest in a cannabis business: by lending the business money or purchasing shares in the business. Regardless of which approach you take, the process is pretty easy. For example, if you're lending someone you know money to start a cannabis business, you have your attorney draw up a loan contract, and you and an authorized representative of the business sign the loan contract, after which you provide the agreed-upon capital. If the business issues bonds, you can buy bonds instead of using a loan contract. And if the business issues shares of stock, you simply buy shares at an agreed-upon price.

You can also buy stocks and bonds by purchasing shares of an ETF or mutual fund. These funds have a collection of investment securities (stocks and bonds) from different businesses and often different industries, which facilitates diversification; you're not putting all your eggs in one basket. (See the earlier section "Diversifying with exchange-traded funds and mutual funds" for details.)

The actual process of buying stocks, bonds, ETFs, or mutual funds is easy. You set up an account with a *broker* — a person who's licensed to buy and sell stocks and bonds, or a company that enables you to place your own orders online. You can then contact your broker to place your order or log into your online brokerage account and place the order yourself.

Regardless of whether you place orders through a broker or an online system, you need to specify several details, including the following:



WARNING

- » The company name or ticker symbol
- » Whether you want to buy or sell
- » The number of shares you want to buy or sell (when selling, you usually have an option to sell all shares or a specified number of shares)
- » The order type:
  - **Market:** Buy or sell the security immediately at the going price.
  - **Limit:** Buy or sell the security only at the specified price or better.
  - **Stop loss:** Buy or sell the security as soon as its price reaches the price specified.
  - **Stop limit:** Buy or sell the security as soon as its price reaches the price specified but only within the specified price range.
  - **Trailing stop:** Buy or sell the security as soon as its price reaches a specified percentage or dollar amount above or below the current market price. With a trailing stop, as the price of the security moves in a favorable direction, the trailing stop price adjusts automatically, but as soon as the price turns in an unfavorable direction by the dollar amount or percentage

specified, the trade is triggered. (Trailing stop orders can be trailing stop loss or trailing stop limit orders.)

» The timeframe:

- **Good till cancelled:** Keep the order open until you choose to cancel it.
- **Fill or kill:** Execute the transaction immediately and completely or cancel it.
- **Immediate or cancel:** Fill as much of the order as possible in the next few seconds and then cancel anything that couldn't be filled.
- **On open:** Execute the order as soon as the market opens.
- **On close:** Execute the order after the market closes.

Because many cannabis companies are not profitable (especially early on), be aware of the difference between investing and speculating:

- » *Investing* involves generating a reasonable return from a profitable company.
- » *Speculating* involves betting on a company's ability to become profitable or betting that other people will buy shares speculatively, driving up the share price. Buying shares of unprofitable companies is more about speculating than investing.

