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Valuing Private Companies in the Cannabis Industry

By Noam Hirschberger, CFA, CVA, Director

Cannabis companies need to be valued for many reasons. Funds need to report the value of their investments to their limited partners. Private companies need to value their shares when issuing equity compensation to executives. Business partners need to value their company for buyout purposes. While all of the aforementioned reasons are not unique to the cannabis industry, there are many unique valuation considerations that are relevant only to this emerging industry. In this article, we will address some of the most salient considerations.

Federal Taxes: Section 280E

Cannabis companies (at least those that that are plant touching) are subject to IRC Section 280E, which means they are not allowed to deduct operating expenses; they can only deduct gross expenses. Cannabis companies often pay effective tax rates of around 70-80 percent!

Given that 280E disallows deductions of operating expenses, this needs to be reflected in the discounted cash flow analysis. Therefore, the valuation analysts should tax affect gross income rather than operating income. Some valuation analysts assume that 280E will disappear, and they, therefore, will switch from tax affecting gross income to operating income at some point in their forecast. This assumption has merit and there is no consensus on the issue because the industry is so new. Having said that, most industry observers believe that there is no path to getting rid of 280E in the very near future, and, therefore, a discounted cash flow should tax affect gross income at least in the early years, if not into perpetuity.

Tax Structure

In order to minimize the company's exposure to 280E, it's not uncommon for a cannabis company to create separate legal structures for its plant touching activities and its non-plant touching activities. For example, a company may put its intellectual property, its brands, etc. for which it receives licensing revenue (i.e., a non-plant touching activity) in a separate entity from its dispensary or cultivation sites (i.e., plant touching activities). Therefore, tax affecting 100% of the company's total gross income (from plant touching and non-plant touching) may be overstating the company's future tax liabilities.

To more accurately capture the expected tax liability, it may be necessary to perform several discounted cash flow analyses: one for the plant touching business and another for the non-plant touching business.

Cost of Goods Sold (COGS)

Cannabis companies employ a multitude of sophisticated strategies to increase the overall tax efficiency of their operations. One common approach entails shifting certain expenses away from operating categories, which may not be deductible under 280E, into COGS, which may render them deductible. In fact, in the case of a cultivator, an argument can be made that all of its expenses constitute components of COGS. Caution should be exercised, however, in light of certain Internal Revenue Code provisions which expressly state that an expense which is not otherwise deductible does not become so by virtue of being

included within COGS.

As one might expect, a cannabis company's overall tax strategy is extremely dependent on the facts and circumstances of each situation. The optimal tax posture is typically worked out jointly between management and its tax advisors. The valuation analyst needs to understand the Company's tax strategy in order to proper allocate between deductible (COGS) and non deductible (opex) expenses in a discounted cash flow analysis.

Bonus Depreciation

The Tax Cuts and Jobs Act (TCJA) was passed in 2017, and one of the provisions of the new law is that companies can depreciate the full amount of most types of capital expenditures in the year in which the investment was made instead of depreciating it over a longer life. However, it should be noted that real estate investments are not eligible for bonus depreciation. Therefore, when valuing cultivators or other cannabis businesses with significant real estate, it may be necessary to bifurcate depreciation expenses eligible for bonus depreciation vs. real estate depreciation which is depreciated over a longer life.

Contact Us

As this article illustrates, there are many industry specific nuances to performing valuations in the cannabis industry. For questions on the subject, please contact:

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