DAVIS + GILBERT

Key Considerations for Cannabis Borrowers

The Bottom Line

- Cannabis-related businesses face particular hurdles when seeking financing, but preparation and proper expectations can overcome them.
- A borrower's ability to communicate knowledgably with a potential lender about its business and the cannabis marketplace and anticipate lender concerns are the keys to success.

For cannabis-related entities in need of financing, there a limited number of options compared to the general market. As the industry grows, and demand for funds to support this growth potentially outstrips the supply of financiers willing to enter the space, the burden is on the company to make itself an attractive credit party.

As the cannabis industry expands to New York, the storied national banks headquartered in New York are not ready to offer banking services to cannabis-related businesses. And going forward, traditional offerings from national banks and financial institutions will continue to be off-limits, at least as long as non-hemp cannabis remains a Schedule I drug under federal law.

As a result, many borrowers in the industry have turned to private investors and regional banks and credit unions for debt financing and traditional banking services. While lender profiles can vary greatly, many are private investors or
state-chartered banking institutions (for debt financing relating to Medicinal Use and hemp companies in particular) who offer cannabis-related financial products only to in-state businesses. Obtaining financing and other financial accommodations from these lenders is not without its own challenges.

As lenders in the space face particular risks and challenges, it is up to the prospective borrower to present itself in the most favorable light, overcome any lender hesitancy, and obtain the financing needed.

Below are key considerations for borrowers to come to the negotiating table prepared and with proper expectations:

Know What Could Impact a Lender's Analysis

Prospective borrowers need to keep in mind the following questions about their companies:

- Does the company have operational history or is it pre-launch?
- Does it "touch the plant" or are its products ancillary to the cannabis market (e.g., apparel, paraphernalia, IP, etc.)?
- Does the company hold assets other than its cannabis products (e.g., real estate, equipment or leases)?
- These factors, among others, can greatly impact a prospective lender's analysis of the company's credit risk.

Diligence, Diligence, Diligence

The prospective lender will engage in a lengthy and costly due diligence process, closely examining the company's financials, equity holders, corporate charter and licenses, IP, business and strategic plans, assets, inventory, receivables, invoices, compliance monitoring capabilities, and material contracts, among other things. Vet the lender. In some states, like California, the lender and loan must be disclosed to state regulators.

Expect to Pay a Premium

Cannabis businesses continue to be viewed as riskier products despite the strength and growth of the industry and in-state legality (where applicable). This perceived risk is reflected in higher interest rates, facility fees and other borrowing costs. The increased costs are also reflected in other banking fees — for example, to compensate banks for the additional reporting and monitoring obligations, it is not uncommon for cannabis businesses to pay thousands in monthly fees to maintain a bank account.

Consider Borrowing Options

The cannabis lending market continues to innovate and grow, adding options from a rising number of private lenders (and, to a smaller extent, regional banks) which have emerged to service the cannabis market and tout their familiarity with it. It's worth discussing pricing with more than one prospective lender. However, it is important to note that equity issuances and convertible securities offerings continue to play a vital role in capital raising activing in the industry.

Expect the Best, Prepare for the Worst

Have a clear plan for profitability and engage in a healthy review of the company's potential business pain points. Importantly, federal bankruptcy protection is generally unavailable for cannabis businesses, which currently are limited to availing themselves of state law remedies if they suffer severe liquidity events. Understanding potential stumbling blocks will help the company prepare for flexibility in advance when negotiating the credit facility.

Related People

Joseph Cioffi
Chief Operating Partner/Chair
212 468 4875
jcioffi@dglaw.com

Joel M. Melendez
Associate
646 673 8324
jmelendez@dglaw.com