Torkin Manes
Barristers & Solicitors

November 2020

Consolidation in the cannabis retail space: Are you ready?

By Andrew J. Wilder and Jonathan Mahoney

It has been just over two years since recreational cannabis has been legalized in Canada. Each province and territory was charged with setting up the rules for sale of recreational cannabis in its jurisdiction. As one might expect in Canada, the regulatory regimes vary and the rollout of retail has not be consistent, with some jurisdictions opting for a lottery process and others allowing anyone eligible to apply to open a store.

In Ontario, there were two lotteries prior to opening up cannabis retail to the public at the beginning of 2020, which has contributed to many more cannabis retail stores opening over the last year. There are approximately 1,200 cannabis retail stores open for operations across the country with the expectation that at least another 1,000 will open over the coming year. Given that Canadians spent $244.9 million on recreational cannabis in August 2020, which is $12.2 million higher than in July 2020 and up $119 million year-over-year, with every province and territory posting monthly sales gains, it is no surprise that many Canadians are anxious to participate in this new budding industry. However, unfortunately the licensing process has, at times, been inconsistent, cumbersome and time consuming which is putting a financial strain on many potential new operators.

In Ontario, there is still a significant backlog of applicants to be issued Retail Store Authorizations (RSAs) by the Alcohol and Gaming Commission of Ontario (AGCO), which is required before you can open your doors for business. To obtain an RSA, an applicant must either own a property or have entered into a binding lease for suitable premises to operate its cannabis retail store. As a result, there are hundreds of applicants for RSAs who have entered into leases and are paying rent, but are unable to presently earn any revenue from their stores, while they wait to be issued a RSA. This has caused a significant financial stress on many applicants and has led to increased mergers and acquisitions (M&A) activity in the cannabis retail space. Faced with this uncertainty and delay, some would-be operators are reconsidering their retail cannabis aspirations and considering what their options are to monetize their interests and cut their losses by looking for potential third parties to take over their leases, and if in operation, purchase their businesses.

Cannabis retail sector M&A in 2020

The initial M&A activity commenced at the beginning of 2020 and was led by certain retailers acquiring stores from past lottery winners, including Choom's acquisition of its Niagara Falls store, Fire & Flower's acquisition of a store in Kingston and in Ottawa, Superette's acquisition of its Ottawa store, High Tide's acquisition of two stores, one in Sudbury and the other in Hamilton, Tokyo Smoke's acquisition of a store in London and Meta Growth's acquisition of a store in each of Waterloo, Kitchener and Toronto. We expect this activity to continue in the months ahead as lottery winners and retailers often have contractual rights in their agreements to force the purchase or sale of the cannabis store based on pre-existing contractual arrangements.

As the year has progressed, we have seen this M&A activity expand from lottery winners to M&A involving larger more established industry participants. Examples of this include, Delta 9's recent announcement that it is purchasing a retail cannabis store in Saskatchewan from Auxly Cannabis, Choom's acquisition of three cannabis retail stores in British Columbia and four stores in Alberta, Fire & Flower's recent purchase of Meta Growth's Toronto store and its acquisition of three additional cannabis retail stores in the GTA. Some of these acquisitions are still subject to conditions, but are expected to close in the coming months. In addition to these proposed acquisitions, it was announced at the end of August of this year that High Tide will merge with Meta Growth that combined will have approximately 63 stores across Canada, which is expected to close in the fourth quarter of this year. All of this M&A activity is leading to increased consolidation in the cannabis retail sector.

With increasing activity in the cannabis retail M&A space, it is critical to understand the nuances of selling a highly regulated cannabis retail store. Such transactions typically involve a share purchase or an asset purchase between the participants.

Share transactions in cannabis retail space

A share sale, which is typically favoured by the seller, occurs when all of the shares of a corporation are sold, effectively changing the control of the corporation from the sellers, to the buyer. When a buyer purchases all of the shares of the corporation, the purchase includes the underlying assets and liabilities (known and unknown) of the corporation. In such a transaction, the proceeds of the sale are paid directly to the prior owners of the corporation (being the shareholder(s)) and, as such, only taxed at the shareholder level.

In the Ontario cannabis space, the required licences, being a Retail Operators Licence (a ROL) and an RSA are typically held by the corporation, and not the corporation's owners. As such, upon completion of a share sale, the owner of the ROL and the RSA will remain the same and the shareholders (i.e. owners) of the corporation will change. Therefore, there is no requirement on a share sale that a new ROL or a new RSA be issued. Instead, the buyer, as the future owner of the corporate licence holder, will be subject to the eligibility requirements set out in the Cannabis Licence Act, 2018 (the CLA) as well as rules and standards set by the AGCO.

In confirming compliance with the CLA and the AGCO's rules and standards, the AGCO will conduct diligence on the buyer group, and the buyer group will have to be approved by the AGCO before a share transaction can be completed. It is difficult to predict how long the AGCO's diligence process will take in any given transaction. If the goal is to have this process completed as soon as possible so that the transaction may close quickly, it should be noted that the level of complexity of the buyer group will impact how long the AGCO's diligence will take. If the buyer's structure is simple (i.e. if it is a single individual or a wholly owned corporation by one individual), the AGCO will only need to conduct its diligence on that one person, and the process can, in theory, be concluded relatively quickly.

However, if the buyer's structure is a complex one that involves many directors, shareholders and officers (and perhaps holding corporations, etc.), the process will certainly be lengthier as the AGCO will conduct diligence on each entity and individual within the structure.

Asset transactions in cannabis retail space

The other common way to purchase a cannabis retail store is by way of an asset sale, which is typically preferred by the buyer. This structure consists of the sale of individual assets used in the operation of the business, which allows the buyer to select those specific assets that it wishes to purchase and the liabilities it wishes to assume or exclude.

In an asset sale the owner of the ROL and the RSA will change on closing and effectively become those of the buyer. This requires the buyer to apply for, and be issued both a ROL and an RSA prior to the sale being completed. This will involve the buyer paying the associated filing fees for these applications, which currently cost $6,000 and $4,000, respectively. Further, similar to the process completed on a share transaction, in determining whether to issue the buyer an ROL and an RSA, the AGCO will conduct a due diligence review to ensure that the buyer meets all applicable eligibility requirements prior to being issued the necessary ROL and RSA.

On an asset transaction, in addition to the buyer having to be issued an ROL and a RSA, there is a further consideration related specifically to cannabis inventory. To transfer the seller's cannabis inventory to the buyer involves working with the Ontario Cannabis Store (the OCS). Having the OCS approve the transfer of cannabis inventory from the seller to the buyer is a three-step process that requires: (i) the seller and buyer prepare a report to OCS setting out what cannabis inventory is to be sold; (ii) the OCS will value the inventory based on current wholesale prices and will send the buyer an invoice for such amount; and (iii) the buyer will pay the invoice and upon receipt of payment, the OCS will refund such amount to the seller.

Getting approval to sell a cannabis retail store requires co-ordination between the buyer, the seller and the AGCO (and if the sale is an asset sale, the OCS as well) and therefore can take some time to finalize and close. Fortunately, in an effort to make the steps as clear and as simple as possible, the AGCO and OCS have established guidelines to help one navigate through the steps and have historically been quite co-operative to deal with. So no matter how you wish to structure the sale of your cannabis retail store, in Ontario, it will involve the AGCO and the OCS.

Due to increased competition, as more and more stores open across the country, and the current delays to obtain the necessary licences to operate cannabis retail stores by the applicable regulatory bodies, we expect to see increased M&A activity and further consolidation in the cannabis retail space. This will involve larger transactions such as the merger of High Tide and Meta Growth and smaller transactions with independent stores being acquired by more established brands and new entrants into the cannabis retail space.

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This article was originally published by The Lawyer’s Daily, part of LexisNexis Canada Inc.

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