OPINION

Up in Smoke

Michigan's recreational cannabis sector has reached nearly $2 billion in annual sales in less than three years, but prices are dropping amid rising competition from outside players and market saturation.

BY MARCO EADIE

As Michigan continues to roll out recreational cannabis sales that, in less than three years, have reached nearly $2 billion in overall annual revenue, the industry is fast approaching market maturity.

While there's room for further growth as cities including Detroit and Traverse City prepare to open the doors to retail cannabis sales, things like saturation, price deflation, and excess capacity are creating a new set of challenges.

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The cannabis sector still has opportunities for generating revenue among operators as new products are added, both from local and national sources, while the related construction trade, supplier base, and service providers in the state drive economic activity. In turn, the market has created demand for once-vacant industrial buildings and commercial spaces.

After years of debate, the Detroit City Council recently passed a recreational marijuana ordinance — and it is, perhaps, a harbinger of growth. The market shift adding recreational sales to medical uses will allow for up to 100 retail licenses, which will be offered via a lottery system.

Traverse City officials, meanwhile, recently said the city will allow for up to 24 recreational licenses among a population of more than 15,000 people. As other communities debate allowing recreational sales, the cannabis market likely won't be as robust when new stores are finally approved and opened.

Cannabis operations in some regions in Michigan have halted production until pricing levels rise, while others are reorganizing in a bid to maintain sound gross margins. The sea of changing market conditions has left some major multistate operators and other investors rethinking their acquisition strategy.

Large multistate brands with footholds in Michigan have decided to pull back on their expansion efforts in other states, as well. Most notably, Canada's Aurora Cannabis is set to close facilities across three continents as it looks to regain profitability. This includes the sale of a large greenhouse for a fraction of what was spent on developing and building the facility.

All of this offers a case study for Michigan cannabis companies as they race for market share, but at what cost? Based on market data, we can expect continued M&A activity in 2022 in the sector, as investors focus on vertical integration in key markets, expanding geographical footprints, and maximizing individual brand awareness.

As new states have come online, this year has been fairly robust for M&As, led by Cresco Labs' acquisition of Columbia Care, which includes operations in several states, at an estimated transaction value of $2 billion. In Michigan, groups such as New Standard, Curaleaf, C3 Industries, Pleasantrees, and TerrAscend have expanded their brand presence locally.

Gage Cannabis in Detroit, meanwhile, recently entered into an all-stock agreement to be acquired by TerrAscend in a deal estimated at $545 million. Most of this value is based on an aggressive growth strategy and expansion in the state — a daunting task now that flower prices have hit a floor.

Michigan is unique in the sense that communities decide which purveyors will get a license, and how many will be issued. This is something to take into account when considering the sector as a seller, given a good deal of enterprise value can be based off forecasted earnings and how fast a given operator can grow.

One of the biggest issues that developed at the tail end of 2021 was price deflation. While every state offering recreational cannabis sales has experienced some form of price compression, Michigan has been leading the nation from a wholesale level with spot prices down 54 percent year-over-year, according to the National Survey on Drug Use and Health and Cowen and Co.

"The struggle we see now (in Michigan) is that there are many more out-of-state brands, as well as new local brands, all competing for limited shelf space," says John McLeod, CEO of Cloud Cannabis.

Cultivators want stable channels to sell their product at a fair price. With an influx of new brands, the competition grows and the resulting excess supply drives down the price of flowers. Can we expect new brands to pay for shelf space as they compete for consumer approval going into the tail end of 2022?

While we celebrate a new business sector in cannabis, we must not forget that some of the "best practices" learned through other businesses can be applied to cannabis operations. Price deflation will weed out poorly planned operations, while allowing others to gain market share through scalable growth strategies.

As it stands, large national players will continue to drive expansion through the state with heavily capitalized investments. But for anyone looking to invest in the sector, it's best to develop a sound investment strategy to take advantage of growth opportunities. DB

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