



High Hopes and Blunt Truths for the \$2.3 Billion Legal Marijuana Market

6:00am EST

Justin Hartfield knows weed. He founded his company Weedmaps, a sort of Yelp for marijuana dispensaries, in 2008, and now serves on the board of directors for the National Cannabis Industry Association, the Marijuana Policy Project and the National Organization for the Reform of Marijuana Laws, which most people know as NORML and for which he also serves as treasurer.

But before all that came his pot-shop epiphany, and before the epiphany he was just a California dude with a brand-new medical marijuana card burning a hole in his pocket.

Hartfield walked into his first dispensary in Los Angeles not knowing his cannabis indica from his cannabis sativa. He found himself confronting at least a dozen jars full of different strains of weed. The sheer variety and abundance blew his mind.

"Until then, I just thought marijuana was marijuana," he says now, explaining how the shop employees dissected for him the finer points of cannabis appreciation. "By the time I walked out, I saw a business."

Justin Hartfield, CEO of Ghost Group and founder of Weedmaps, standing in a 420-square-foot hydroponic marijuana grow facility in Orange, Calif. in December 2013.

Image credit: Ghost Group

Weedmaps provides the menus and pricing of legal marijuana dispensaries across the United States. Visitors can access the site for free, while business owners pay a monthly fee to manage their pages. Hartfield says the site is tracking half a million products in real time, "not just strains but also edibles, lotions, tinctures, salves, balms, clothing, bongs, vaporizers. Anything a dispensary sells is on our weed menu." Weedmaps brought in most of the \$30 million in revenue that its parent company, Ghost Group, which Hartfield also runs, earned last year.

In early January 2014, the Weedmaps website had a special message for visitors. "Congratulations, Colorado! Now you can find adult use dispensaries near you," it said.

"Adult use" is the marijuana industry's preferred euphemism for legal recreational use of cannabis, weed, pot -- call it what you like. Marijuana became legal for recreational purchase and use in Colorado on the first of this year, and adult-use facilities are doing a booming business. Shop owners estimated that in their first day they made more than \$1 million in collective sales.

At Brooke Gehring's dispensary in Edgewater, Colo., a suburb of Denver, 592 recreational customers showed up on Jan. 1. By contrast, only four patients came in for medical weed that day. Since then, more than 2,500 recreational users have come through the doors, more customers than the shop had seen in the previous two months combined. The average purchase was more than \$100, with taxes levied by the state included in the price.

Colorado has high hopes for legal marijuana. The state believes the industry could rake in nearly \$600 million in revenue this year. That would mean \$67 million in tax revenue for Colorado, of which the first \$20 million is earmarked for schools.

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So far, the state's politicians appear to be pleased with the rollout of recreational marijuana. "I want to thank the businesses and consumers alike for acting responsibly and with great accountability today," Denver's mayor, Michael Hancock, said in a statement on Jan. 1. "Denver is a progressive city, a vibrant city, and it's incumbent on all of us to continue getting this right."

Brooke Gehring, owner of Patients Choice of Colorado, and Milo Yung of Big Buddha Seeds standing in one of Patients Choice of Colorado's flowering rooms in April 2013.

Image credit: Patients Choice of Colorado

Right or not, legal marijuana is here, and it's a growing market. Twenty-one states plus the U.S. capital allow medical marijuana, and two states, Colorado and Washington, decriminalized marijuana for recreational use in 2012. (Washington state's recreational pot shops will open this summer.) Along with Washington, D.C., a total of 15 states allow medical marijuana dispensaries.

A rising tide

This sea change on the state level reflects a rising tide of enthusiasm for legal marijuana. According to Gallup, 58 percent of people nationwide now say they support legalization. And they are putting their money where their mouth is. The U.S. market for legal marijuana, currently

valued at \$1.4 billion, is projected to grow to \$2.3 billion in 2014 and \$10.2 billion in five years, according to a recent report by ArcView Market Research.

In Colorado and Washington state, the combination of broad popular support and potential for extra tax revenue, along with promises to strictly regulate the industry, has convinced the federal government to reserve judgment for the time being. That is, the Obama Administration is willing to permit the adult-use experiment for now, which means in some sense overlooking the fact that marijuana is still, according to federal law, a Schedule 1 narcotic with no known medical value.

It's politically risky for the federal government to ride roughshod over state laws voted in by a majority of the people, says William McGrath, a partner at the Washington, D.C.-based Potomac Law Group. Political calculation also plays a role. "The administration is fully aware of which way the wind is blowing on the issue," McGrath says. "A majority of Americans favor legalization, and there is overwhelming support among younger voters."

In return, however, the Department of Justice has laid out strict requirements that marijuana cultivators and retailers must follow, and Colorado has issued rules of its own. Two documents, totaling more than 230 pages and issued by the Marijuana Enforcement Division, a branch of the Colorado Department of Revenue, spell out the rules for medical and recreational marijuana businesses.

"The oversight is extensive. This business is not for everyone," Gehring says. "We're in a highly regulated industry because of the federal illegalities."

Barriers to entry

For would-be weed entrepreneurs, there are primarily three barriers to entry. The first is the maze of legal requirements. In Colorado, anyone directly involved in the production or distribution of weed must have lived in the state for the past two years, at a minimum. Retail shops and grow operations need licenses, often multiple licenses, for which a public hearing and inspections are mandatory. And like casino workers, Gehring's employees have to be individually licensed by the state. Everyone must pass a background check. And that's only the tip of the iceberg. Even child-resistant packaging is required. "It's a very comprehensive scheme that will require a great deal of expertise that may be foreign to those in the marijuana trade," McGrath says.

Related: Up in Smoke: First Retail Licenses for Marijuana Distributed in Denver

The interior of one of Patients Choice of Colorado's dispensaries in Denver.
Image credit: Patients Choice of Colorado

The second barrier is agricultural knowledge. All marijuana retailers in Colorado are required to grow at least 70 percent of the product they sell. Similarly, all growers are required to run a dispensary. This so-called "vertical integration" requires entrepreneurs to "marry a large-scale agricultural business to a small retail location," says Gehring, who owns Patients Choice of Colorado, a company which operates four dispensaries in the state. "We have thousands of plants that are living organisms that we have to maintain."

This looks set to change in October, when Colorado will allow standalone cultivation and retail operations for the first time, but until then it's the only way to run a legal pot business. More onerous still, every single plant needs an RFID tag so that it can be tracked "from seed to sale." Every weed shop in the state is required to enter this data into the Marijuana Inventory Tracking System, or MITS, which is overseen by the Marijuana Enforcement Division. This is one of the most expensive compliance requirements, Gehring says. In order to open her store for adult-use sales on the first of January, she had to spend \$22,000 on tags alone.

Startup capital is the third barrier. What might at first appear to be a small business in fact requires a multi-million-dollar investment, Gehring says. Between her four dispensaries and her 35,000 square feet of production space, Gehring pays \$115,000 in annual licensing fees. She paid an additional \$27,500 in application fees so that three of her medical dispensaries could start selling recreational pot. And then there are all the other costs associated with running a business that grows a crop, harvests it, packages it, transports it, stocks it and sells it to customers at retail locations.

"This is not just like opening up a flower shop or a sandwich shop," says Gehring. "The overhead just to operate, before you've even built anything..." She falls silent, tallying the costs.

'A rounding error'

Proponents of legalization have long claimed that taking marijuana out of the black market and putting it on store shelves would lower prices and at the same time provide tax opportunities for state and local governments. But Jeffrey Miron, a senior lecturer in economics at Harvard University and a senior fellow at the Cato Institute, is unimpressed with the projections. The \$67 million Colorado hopes to make in additional taxes is "a rounding error" compared to the total state budget, he says. (For fiscal year 2013, Colorado's budget was \$20 billion.) "It's chump change. It's nothing!"

"Of course it's not nothing," he corrects himself. "Yes, you can fund a reasonable number of teachers, or firemen, or whatever cutesy thing you want to use to make it seem important, but spread out across the whole system it will not have a significant impact."

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The line outside of Patients Choice of Colorado's Edgewater location on Jan. 1, 2014, the first day of legal recreational marijuana sales. Some customers waited in line for about three hours to purchase cannabis legally at \$64.90 for an eighth of an ounce.

Image credit: Patients Choice of Colorado

What's more, the costs of setting up and running a new regulatory compliance and enforcement division "will certainly cut into tax revenues from marijuana sales," says McGrath of Potomac Law Group. But he thinks the burgeoning industry will boost the state economy in other ways. "Even if the revenue benefits to the state aren't as much as expected, the industry will create new jobs and bring money into the state as 'pot tourism' grows."

Meanwhile, however, consumer hopes for cheap weed, if they ever existed, are being quietly dashed. Gehring's shop in Edgewater is selling an eighth of an ounce for \$55, which comes out to \$64.90 with taxes. She has heard of retail prices as high as \$75 pre-tax for the same amount. In return, however, pot users get ostensibly higher quality bud and more trustworthy, consistent suppliers.

Investment potential

Most banks remain wary of the weed business. Others would like to lend a helping hand but find themselves stymied by federal law. Jenifer Waller, senior vice president of the Colorado Bankers Association, told Reuters last November that several of her group members "would be very anxious to bank the marijuana industry, but have been told they cannot."

But in the absence of traditional finance, others are stepping up. This week, *High Times*, the long-running magazine for weed enthusiasts, announced that it was launching a private-equity fund to invest in marijuana businesses. The HT Growth Fund wants to raise \$100 million over the next two years for that purpose. It will invest primarily in businesses that, while related to cannabis, are not directly involved in its production or distribution, with investments ranging from \$2 million to \$5 million per company.

Individuals are also investing. Jeffrey Friedland is one of these pioneers. He runs the financial services firm Friedland Global Capital as well as a strategic advisory, Global Corporate Strategies, that helps entrepreneurs gain access to foreign capital. He considers legal marijuana an emerging market. He has been making the rounds in Colorado, driving from one small mountain town to the next, meeting with county and local government officials and visiting the facilities in which he hopes to take an ownership stake -- so far, two dispensaries and their growing facilities. His involvement as an equity owner is pending state regulatory approval.

To Friedland's experienced eye, the potential for profit is hard to miss. At 9 p.m. on Jan. 8, he saw a line out the door of an adult-use dispensary in the town of Breckenridge. "Stores running out of supply short term is a real issue," he says. Prices are high, but weed is still flying off the shelves.

"The first week of sales in Colorado has been a resounding success from a business perspective," McGrath says. "But, because the business is so highly regulated on a state level and the threat of federal as well as state prosecution for violation remains, potential investors will want to take a long, hard look at the operations and the people involved in any investment opportunity."

No more regulated than alcohol

Although it's now legal to buy, hold and smoke pot recreationally in Colorado, it remains illegal to smoke it in public -- even where lighting up a cigarette is okay -- or to drive a car while high. It is also illegal to take pot purchased in Colorado across state lines. And only licensed dispensaries may sell the drug. Person-to-person selling is not allowed, nor is dealing to customers under the age of 21.

"There's somehow this notion that we can legalize it and eliminate the black market at the same time that we can control it and keep it small," Miron says scornfully.

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Anecdotal evidence suggests that increased access to the drug leads to increased demand. It would be naïve to think that people won't still attempt unlicensed grow operations in the hopes of profiting from a cash crop. On Jan. 4, sheriffs in Kiowa County, Colo. arrested two people after discovering a house filled with more than 1,000 plants. The sheriff's office has reportedly asked the federal Drug Enforcement Agency for help with the case.

It will take a lot for legal marijuana to win over law enforcement officials. "The industry needs to prove itself to be transparent, competent and dedicated to compliance with the laws," McGrath says. "If that happens, and that experience is replicated in other states, it would be difficult for a future administration to kill the market."

Even so, Miron recommends caution. "It's still a long way from actually being a legal product. There's all this extra silly regulation that may keep the market a gray area, underground. So while this is an important step because it brings attention to the issue, because it shows that nothing catastrophic will happen if you legalize marijuana, we're still a long way from the goal line."

"At minimum, it should be no more regulated than alcohol," Miron says. "No more than alcohol, tobacco, toaster ovens or Starbucks coffee. It should just be legal, period."