



The Economy of Pot

Are investors right to scramble into marijuana stocks?

By Casey Quinlan , March 14, 2014

It doesn't matter if it's indica or sativa. It all sells out by the end of the day. Toni Fox, the owner of 3D Cannabis Center near downtown Denver, is overwhelmed with the demand created by the state's new recreational marijuana law. She says the store pulls in \$20,000 a day in sales and made \$40,000 on Jan. 1, the day licensed shops began selling recreational marijuana to people age 21 and older.

The majority of Fox's customers are from out of state. On Saturdays, they may wait 20 minutes to purchase marijuana, and limos and charter buses pull up five times a day. Fox is hiring more staff and building new rooms in her store to meet demand, and she eventually aims to open two more locations. She's also leasing 1.35 acres of farmland three hours away in Chaffee County, building hoop houses and greenhouses for cannabis cultivation.

With marijuana now legal in Colorado and Washington and tourism booming, investors and financial pundits are wondering how fast the marijuana industry will grow and if it could become national. The ArcView Group, a San Francisco-based investing and market research firm for high-net-worth investors, estimates the national legal market (including recreational and medical marijuana) at \$1.53 billion in 2013 and expects it to grow to \$2.57 billion by the end of 2014, with marijuana sales in Washington and Colorado pulling in \$316 million and \$802 million, respectively. ArcView says the national market could reach \$10.2 billion in five years.

Legalization is already attracting a slew of investor interest, mostly in penny stocks – low-priced, thinly traded shares that are generally considered speculative investments, according to the Securities and Exchange Commission. These companies, which sell everything from hemp-based health products to e-cigarettes, aim to capitalize on the burgeoning marijuana industry.

Growing pains. The industry faces some significant challenges, which investors should be aware of before jumping into pot stocks. Banks have been reluctant to provide loans to marijuana dispensaries, and interstate trade is illegal, allowing little room for expansion. Even in states where recreational marijuana is legal, there are considerable obstacles.

For example, Washington's Liquor Control Board stipulates that companies cannot have more than three marijuana processor licenses and more than three retail store licenses. The state also imposes a 25 percent excise tax, and stores must be 1,000 feet away from schools, recreational

centers, public transit centers and other facilities. And in both Colorado and Washington, marijuana can only be purchased with cash.

In Kirkland, Wash., Jamen Shively, a former Microsoft executive turned cannabis entrepreneur, founded Diego Pellicer, a “premium” cannabis brand. Shively, who plans to open a retail location this summer, says he envisions his future customer base as well-educated, wealthy, older people who are looking to unwind in their retirement years. “I don’t want it to be known as a brand just appealing to young people,” Shively says.

He aims to eventually open many stores under the Diego Pellicer brand, but three is currently the maximum according to state law. With expansion somewhat limited, Shively hopes to dominate the new industry simply by being “first in people’s minds,” he says, through advertising and news conferences.

Jeffrey Miron, an economist at the Cato Institute, a conservative think tank, says the marijuana industry is not as large and influential as some investors may hope. “People are way overstating the significance of what’s happening,” Miron says. “One should be very cautious when there’s a big change in the industry, and the magnitude of it is not that huge. It is one product that could compete with billions of products like alcohol and tobacco.”

Marijuana innovation. The rollout of legal dispensaries, with more than 150 licensed recreational stores in Colorado, and Washington expected to hold license lotteries for 334 retail stores, is good news for startups aiming to profit from the growing industry.

Most of these companies are privately held, including OpenVape, which makes a device similar to an e-cigarette. The social media site weedmaps.com launched in 2008 and offers a service like Yelp for dispensaries. The privately held company says its 2013 fourth-quarter revenue increased 33 percent from the fourth quarter of 2012.

Other ancillary businesses that may benefit from marijuana legalization include Analytical 360 in Seattle, which tests marijuana potency, and MediSwipe, which provides transaction processing systems to hospitals and medical dispensaries. GreenGro Tech sells equipment favored among marijuana farmers, such as lighting and hydroponics kits.

The risks of marijuana stocks. The Financial Industry Regulatory Authority issued an investor alert in August 2013 warning investors of marijuana stock scams that provide misleading or overly optimistic information.

Gerri Walsh, FINRA's senior vice president, says regulators saw a huge spike in such incidents in January. “There was a significant upswing in trading, and share prices spiked in thinly traded companies and low-priced securities,” Walsh says.

She says investors should look out for red flags such as prior iterations of a business in which the company has used “pump-and-dump” schemes. In such schemes, fraudsters make exaggerated and misleading claims to raise the share price of a company with little or no history of financial success, then sell their holdings at a profit, leaving other investors holding the bag. Walsh says

investors should look up stock symbols using EDGAR, a Securities and Exchange Commission database, to see whether a business has had a "past life."

Most marijuana stocks have limited track records and trade over the counter, which means they are not listed on a national security exchange. They are less liquid, carry more credit risk and publicly available information about them is often limited, so investors should tread carefully.

The business models of these companies vary widely. For example, Seattle-based Plandai researches plant extracts and has partnered with Diego Pellicer to create a line of medical cannabis products. Medical Marijuana Inc. produces cannabinoid-based health and wellness products for the medical marijuana market and MedBox sells medical dispensing systems designed to prevent unauthorized use of drugs in medical facilities. Creative Edge Nutrition, a nutritional supplement company, sells a line of hemp-based protein powder. Vape Holdings deals in e-cigarettes, vaporizers and cannabis concentrates.

Interest in investing in marijuana stems from a "sensible exuberance," says Troy Dayton, CEO of The ArcView Group. People are seeing a large industry going from underground to above ground in a piecemeal fashion, he says, and they're reacting to an opportunity he likens to the dot-com boom.

"How does [the exuberance] translate to stocks? It's a bit of a jump of the shark," Dayton says. "We will see an increase, but most of it is not accessible to the public market. So there will be small, highly speculative penny stocks, some of which are pump-and-dump stocks."

Dayton echoes FINRA's warning about fraudulent activity in some marijuana investments. "Scamsters figured out that the public is excited, and most people are unaware that it's happening," he says.

Dayton says most of the best investments in the industry are in privately held companies, but there are credible deals in the public space. However, he recommends consulting with a financial advisor or someone who specializes in marijuana-related stocks before investing.

The politics of legalization. Growth of the marijuana industry is largely dependent on the pace of legalization. A Gallup poll released in October 2013, which surveyed 1,028 adults in 50 states, shows that Americans' opinions on legalization are changing rapidly. The percentage of those in favor rose 10 percentage points in the past year to 58 percent, while it only rose two percentage points from 1985 to 1997.

Evan Nison, executive director of NORML New Jersey, a nonprofit advocate for marijuana legalization, says if large states like California and New York were to legalize recreational marijuana use, it would raise expectations for national legalization. "I believe it will happen in 10 years, but before then, a lot of dominoes will fall. I believe five or six states could fall by the end of 2016," Nison says.

In November, California voters will have a few ballot measures aimed at legalizing recreational pot use to decide on. Medical marijuana is on the table in New York, where a bill passed the

State Assembly health committee in January. A few other states considering medical or recreational marijuana legalization are Florida, Alaska, South Carolina, Georgia and Alabama.

While recreational marijuana remains limited to Colorado and Washington, interested investors with plenty of money and financial advice may be able buy into private companies, which experts say hold the best opportunities. For average investors, however, it's likely to remain difficult and risky to tap into this budding industry.