# Recreational cannabis – A sea of real estate opportunity clouded by uncertainty

The upcoming legalization of recreational cannabis in Canada on October 17, 2018 is expected to create opportunities for commercial real estate, particularly in the retail category. This emerging sector is already drawing significant investment, but online sales and competition from the illicit market may temper growth and sustainability in brick-and-mortar outlets. In this challenging environment, retailers must make strategic decisions on their business models, while investors and landlords should monitor this sector closely.

## New, lucrative cannabis market fuels strong demand for commercial real estate

As retailers and cannabis companies prepare for the legalization of recreational marijuana in Canada, demand is increasing for commercial real estate, especially in provinces where private companies will be authorized to participate in the market. This is a sizeable opportunity for many businesses—even before legalization, Canadians were spending an estimated $5.7 billion on cannabis, according to Statistics Canada data. CIBC predicts the cannabis industry will overtake the hard liquor market, with a retail value of $6.8 billion by 2020. Factoring in the ancillary market, which includes related products and services, the market could reach up to $20 billion by some estimates.

With the appropriate licensing, retail cannabis provides an opportunity for struggling retailers to make a strategic move into a new market, while also offering an important revenue opportunity for retail landlords in an era where the shift to online shopping is cutting into profit margins and reducing foot traffic to brick and mortar stores. Apart from direct cannabis retailers, industry offshoots such as accessory shops and cannabis cafes could contribute to the demand for additional retail locations.

In order to participate in this growth, licensed retailers are already securing locations and setting up storefronts. Although the specifics of how they are approaching the opportunity varies from province to province, so far it appears that most prefer to lease space to sell their product – and they're willing to pay a premium for the right locations. However, some caution is warranted in this new market, because the regulatory landscape (particularly at the municipal level) remains fluid and the full scope of the competitive landscape will not be known for some time.

## Cannabis retail models in Canada

**Provinces choose three different sales and distribution models**
Beyond the federal legislation legalizing cannabis (Bill C45), retailers need to navigate two additional layers of regulation. Provincial and territorial governments have the responsibility to determine how cannabis is distributed, which includes authority over licensing land use and rules concerning retail locations and sales, such as the number of stores, product pricing, distribution and the age of majority. Municipalities are responsible for issues such as zoning and licensing at a local level. As a result of these differing regulations, some markets may be more attractive than others.

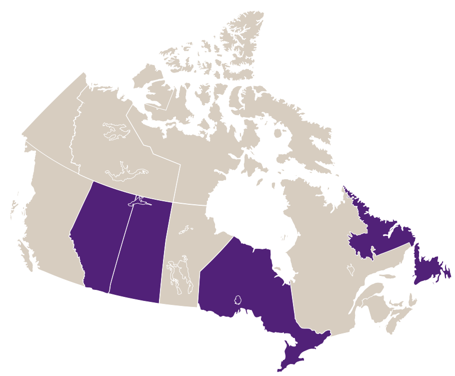
**Broadly speaking, three models are being implemented across Canada, though they are subject to change as regulations and market conditions evolve. These include:**

### Public models:

With the exception of Newfoundland, the Atlantic Provinces are adopting a government-owned model, handing the responsibility for retail cannabis sales to public liquor boards. Quebec is similarly adopting a completely government-run model.
With such public models, the opportunities for private sector retailers are confined to the ancillary market. However, real estate opportunities still exist as the government-owned entities open—and perhaps look to expand—retail locations.

### Private models:

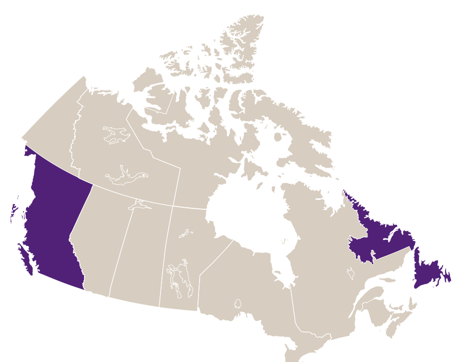
Provinces such as Saskatchewan, Alberta, Ontario and Newfoundland have opted for a fully private approach, providing significant opportunity for both retailers and landlords. The retail opportunity varies markedly by province, however. Alberta is likely to lead the way in this model, with more than 200 stores expected to open and no caps on the number of licenses to be issued, whereas Saskatchewan is expected to issue just 51 retail cannabis licenses in contrast to its approximately 700 liquor licenses. In Ontario, recreational cannabis will be sold in stores by private retailers, and given the size of its population and overall economy, Ontario is expected to be a premier market nationally.



### Hybrid models:

Provinces such as Newfoundland and British Columbia are opting to implement a mixed public-private system.

Each province retains the sole rights over online cannabis sales.



In some cases, the details of these regulatory proposals are still being developed (particularly at the municipal level), and many important details regarding how these various regimes will be enforced remain unclear. Outside of the letter of the law, public perception is also a critical factor in the real estate and retail sectors, and cannabis remains a controversial issue among the general Canadian population. How community residents and neighboring businesses react to cannabis stores in their neighborhoods could have a significant impact on where stores are located.

## Municipalities could adopt their own zoning, advertising restrictions

Before securing retail locations, businesses should understand and factor into their plans and agreements that zoning and advertising requirements may continue to change after legalization. Retailers vying for high traffic, high visibility locations—and perhaps rushing into leasing agreements amid expected price increases—face the risk of municipalities implementing regulations that create new barriers or other challenges to operations. For example, municipalities could place restrictions on locations near establishments frequented by children, set limits on how close cannabis stores can be to other outlets such as liquor stores, pawnshops and payday loan providers, and ultimately restrict the accessibility of retail cannabis.

Municipalities may also decide to block the industry altogether in certain cases. Richmond, B.C., for instance, has decided to ban retail cannabis activities. Other municipalities, such as West Vancouver, are exploring temporary bans. In Ontario, municipalities are being given a one-time chance to opt out of retail cannabis. Oakville, for instance, is expected to opt out if the current council is re-elected, because they have cited a lack of information and a desire not to rush into this decision.

## Regulation and competition: illicit cultivation and sale, home growers may limit retail growth

With a long-established illegal market for cannabis that has survived despite existing enforcement efforts, legal retailers will need to be competitive to secure their market share. Compounding this difficulty, marketing of cannabis products will be severely restricted like tobacco, as federal regulations require a single, uniform packaging color without images other than a logo and a health warning. There are also prohibitions on companies marketing cannabis using broadcast advertisements. In addition, consumers will be able to grow up to four plants of cannabis, which has the potential to erode retail sales volume.

Possible supply bottlenecks, marketing and branding restrictions, downward pressure on prices and an unfavourable cost structure could all increase pressure on the legal market. Marketing restrictions carry some of the most significant consequences, as the federal government has stated that companies violating advertising or packaging rules could face license suspensions, steep fines or revocations.

Some cannabis companies are currently operating in a bit of a grey area when it comes to marketing and creating brand awareness by leveraging creative tactics such as augmented reality, event sponsorships, and co-branded products like beer. Though it remains unclear how strictly marketing restrictions will be enforced in the future, the in-store aesthetics, service and design of retail stores will likely play a role in efforts by licensed retailers to attract and retain customers.

Another important element of efforts to attract consumers to licensed retailers is access to legal stores. In Manitoba, for instance, the province has set a goal of having licensed stores within a 30-minute drive for 90% of the population. This expansion will not only support the competitiveness of the legal market but also provide opportunities for retailers and real estate owners.

## The unique risks of cannabis real estate commercial leases should provide for contingencies specific to cannabis sector

Despite ongoing regulatory uncertainty, retailers are moving quickly to secure real estate in prime locations—committing to long-term leases and paying a premium to market rents. Cannabis companies are looking to lease retail locations with 1,200 to 3,000 square feet of space, preferably with street front or mall locations. Small and large companies alike are competing for the space, driving up prices and terms, including aggressive termination clauses. Bidding wars have already driven some companies to offer double rent, with leases being signed for five to ten years.

The long-term implications for commercial real estate in Canada remain to be seen. There are not many comparable cases to study for clues, though in Denver, property prices near medical cannabis shops converted to recreational shops increased after the state of Colorado legalized recreational sales. The potential upside for commercial real estate owners includes premium rents, increased foot traffic to existing assets, elevated property values, and positive spillover effects of successful retail cannabis stores.

It is possible, however, that the Canadian experience will be different. The reaction from community residents and other store owners to cannabis retailers may be less enthusiastic, for instance, or the stores may not generate the anticipated sales volume and increased foot traffic due to competitive forces. In other cases, a shift in licensing practices or other regulations may negatively impact retail performance.

Some cannabis retailers are being so aggressive in their bid for prime locations that they are making non-refundable deposits and providing personal guarantees on leases. Small retailers making deals with guarantees on personal assets face critical risks. Landlords and retailers could mitigate these risks by adding contingency clauses to rental agreements to cover specific factors such as licence approval.

For cannabis retailers and landlords, a central consideration for lease agreements will be use provisions. Retailers will need to ensure cannabis sale or use is permitted, while landlords may wish to include provisions requiring that tenants hold the applicable licenses and are complying with municipal, provincial and federal regulations. Without carefully crafted lease agreements, landlords could face legal action for illicit cannabis operations. The City of Victoria, for instance, is considering legal action against landlords leasing to illegal dispensaries.

Indemnification provisions could also be considered as protection against potentially stronger risks of breaking and entering. Cannabis retailers might incur more damages than other retailers because the particularly strong smell of their product is difficult to mask. Since there are unique regulatory and compliance risks in the cannabis sector, commercial lease agreements should provide for these contingencies with unique sub-letting and termination provisions. Even residential lease agreements could take into account risks pertaining to the growth of cannabis at home and include similar provisions to protect property values.

## Institutional real estate ownership in the cannabis sector

In the industrial sector, cannabis growers have secured as much as 50 million square feet of space – and major suppliers are buying real estate with institutional partners, including real estate investment funds and pension funds. Similar trends might arise in the retail sector, where REITs may acquire—or already own—retail outlets in locations ideal for cannabis stores.

These REITs may offer an opportunity for investors to enter this industry with less risk than direct investments, by acquiring retail properties and leasing those out to cannabis companies, generating a potentially predictable cash flow. Through sales-leaseback transactions, these REITs may allow cannabis companies to secure capital for higher return activities. Their ability to unlock cash may prove attractive as more interest and capital starts flowing into the industry as it matures.

Pension funds were initially skeptical of the cannabis market, but some major organizations such as BCIMC and Canada Post are changing course and now making early investments in cannabis companies, with expectations that a steady flow of pension fund investments will lead to more widespread interest in the sector. As the perception of risk in the sector shifts and investor confidence grows, volatility in the sector will slowly start to decline (though it may take a few years to settle) which could drive more pension funds to take on larger positions in the sector.

## Our team is here to help

The legalization of recreational cannabis sales in Canada offers new opportunities for real estate owners and retailers, though there are also risks associated with operating in uncharted waters. Our advisors are tracking the changes in the market landscape, including the evolving regulatory regimes. If you are involved in this exciting field—or even considering entering it—please feel free to talk to us and tap into our expertise.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