Cannabis strains: Industry risks and warning signs

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Over the second half of 2019, headlines surrounding growth and product diversification in the Canadian cannabis industry gave way to speculation about its future potential failures, insolvencies and consolidations.

In 2019, five Canadian cannabis companies became subject to formal insolvency proceedings under the *Companies' Creditors Arrangement Act* (CCAA) or the *Bankruptcy and Insolvency Act* (the BIA). The first was Ascent Industries Corp. in March of 2019, which filed for protection under the CCAA. Followed by secured creditors applying under the BIA to appoint receivers over the property and assets of each of 2368523 Ontario Ltd. (dba Curative Cannabis) and DionyMed Brands Inc. In December 2019, Wayland Group Corp. and AgMedica Bioscience Inc. each filed for protection under the CCAA.

On filing, none of Ascent, Dionymed or Curative Cannabis held an active cannabis licence in Canada. Ascent required creditor protection because suspension of its licence issued under the *Access to Cannabis for Medical Purposes Regulations* halted its ability to generate revenue in Canada, leading to payment defaults. During its CCAA proceedings, Ascent sold its Canadian facilities. In contrast, on filing, each of Wayland and AgMedica was authorized for cultivation, processing and medical sale under the *Cannabis Regulations* and each had supply agreements with provincial liquor and cannabis authorities for the adult use market. Despite their ability to generate revenue, neither Wayland nor AgMedica was able to meet obligations to creditors and required protection to pursue a restructuring.

It is widely speculated that 2020 will see additional cannabis companies seeking creditor protection, including under the CCAA, and creditors enforcing their rights, including through bankruptcy or receivership orders under the BIA.

Market data shows licence holders across Canada face significant challenges in their path to revenue. While adult use sales have grown each month since March 2019, excess inventory of both unprocessed cannabis and of cannabis products continues and there are significant obstacles between processors and product sales, including insufficient retail capacity in Ontario. Further, the infrastructure required for the newly saleable classes of cannabis – edible cannabis, cannabis concentrates (and other

cannabis extracts beyond cannabis oil) and cannabis topical products – is capital intensive. In addition, three provinces have banned or slowed the introduction of concentrates in cartridges or vape pens, limiting the market for these popular products (and maintaining an opportunity for illicit actors). These challenges are in addition to compliance and market pressure.

Watching for signs of potential financial distress is prudent practice, particularly for an industry in a period of transition. Common examples of signs that may indicate a company is at risk of financial distress, and that our Cannabis Industry Group can help, include:

- Business specific risks: losing a key customer or supplier, or suspension of a licence, can exacerbate or precipitate financial challenges;
- Negative cash flow: spending more than the business earns is not sustainable, although in the short term deliberate investments may be advisable or necessary (but should be carefully considered)
- Declining revenue or weak profits: generating revenue is critical to avoiding financial distress;
- Difficulty securing capital on favourable terms: this may indicate that those assessing the business are uncertain as to its future viability;
- Near-term payment obligations without a path to repayment: missing payments is a clear sign of financial distress and taking proactive steps can help avoid, or navigate, this outcome;
- Defaulting on payments: as noted above, missing payments is a clear sign of financial distress, and puts a company at risk of its creditors taking steps to collect the amounts owed which will, at a minimum, disrupt the business; and
- Inability to meet obligations in existing agreements: if a company is unable to meet commitments under existing agreements, it is likely facing constraints on its cash flow or resources.

A proactive approach to restructuring will best position companies to navigate these challenges. Current and complete financial information will ensure companies are able to recognize potential issues at an early stage, allowing development of strategies to mitigate or avoid the potential issues. Involving financial and legal advisors at an early stage can also help improve outcomes since strategic options decrease as the company's financial position deteriorates. Taking action early is often a key factor in a successful restructuring.

Conversely, market distress creates opportunities. Cannabis companies may wish to monitor the performance of their competitors, particularly those with assets or other strengths that would be attractive acquisition targets, so that they can take advantage of potential acquisition opportunities should they arise.

BLG's Cannabis Industry Expertise

With broad industry experience and particular expertise in cannabis restructurings, BLG is here to help our clients navigate the challenges and opportunities presented by the unforgiving fiscal environment that 2020 is expected to bring. Our team advises clients to help proactively assess risks and options to improve their financial situation, including potential restructuring options, and assessing potential acquisitions of distressed entities and assets. We support our clients to help position themselves to survive the

current financial climate, and to thrive by taking advantage of opportunities presented by distressed competitors.

As Canada's largest law firm, BLG continues to serve the cannabis industry nation-wide, leveraging its national expertise in regulatory compliance, corporate finance, mergers and acquisitions, insolvency and restructuring proceedings, and many other practice groups. Given BLG's deep experience in the cannabis industry and its broadly based national platform, BLG lawyers are ably situated to advise management of any cannabis company based on their unique situation to gain the maximum competitive advantage in the rapidly changing cannabis landscape. Our familiarity with cultivation, processing, medical sale, adult use retail sale, analytical testing and research licences, and with industry practices more broadly, bring tremendous value to our clients working in and adjacent to the cannabis industry. Our expertise brings value during this challenging period of maturation and consolidation, just as it did during the previous phases of explosive growth and speculation.

By

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Expertise

Insolvency & Restructuring

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