

CA Cultivation Tax Elimination, Meaningfully Eases Pricing Pressures and Likely Drives Consolidation

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Last week, California's onerous cultivation tax (\$161/lb.) was officially eliminated. While far from solving all the issues for California operators, the tax change meaningfully reduces the break-even threshold for growers and particularly those with the biggest scale in capacity. In California, scale permits a meaningful wholesale price premium as retailers and distributors are typically willing to pay up to consolidate relationships as well as a lower total cost of production on greater volumes. The other driver of premium wholesale pricing is branded products. Brand power also tends to come with scale of operation given that brand success in the space is still largely predicated on distribution.

Some savings are likely to be passed on to distributors and retailers however without that we believe the total cost of production for outdoor growers is reduced by more than 40% with the elimination of the tax and the breakeven price for wholesalers is lowered from ~\$375 to \$214. The average price of outdoor grown flower in the state today is approximately \$400/lbs and has been as low as \$300 earlier this year.

Stocks for California operators have outperformed in recent months, in part on this expected law change. We expect stock outperformance to continue in the near term as market conditions for operators become more tenable which will translate to better earnings results than we have seen in the past and give investors greater confidence in long term opportunities. We also expect easier market conditions will accelerate consolidation in the state given the advantages of scale and the fact that larger operators now have more capital available to spend. Of public currently California-centric names, we expect 4front, Glasshouse, Harborside, Lowell, Parent Company and Planet 13 with each having already been acquisitive prior to the change.

The lower break-even threshold and seemingly more accommodating regulatory environment may also be the catalyst that finally brings the biggest MSOs into California. At some point, California as a market is too big to avoid and given the fact that California centric names continue to trade at meaningful valuation we expect entry to come through M&A. All of the above mentioned public operators along with smaller public companies including: Body & Mind, Fiore, Unrivaled and Vibe are in play to be acquired in the near term and thus warrant further investor consideration. Within our coverage, we suspect that Ascend, AYR, Jushi, Schwazze and TILT are likely to be the most interested in new California expansion.

Tax Change Discriminately Benefits Outdoor Growers

On the topic of cost savings for California cultivators, we revisit a recent Viridian Capital "Chart of the Week". While it is unclear how much of the tax savings will be shared with distributors, retailers and even customers, on its own the elimination of the cultivation tax enhances gross profit margins by 25% on average with the greatest beneficiary being outdoor growers. Based on an assumed \$400/lbs. price for outdoor flower and a cost of production of \$214/lbs., outdoor growers in California will enhance gross profits by roughly 40% from 6% to 47%. We note that today's achievable 6% profit level is significantly higher than the level possible earlier this year and throughout second half 2021 when nearly all outdoor growers in California were fully underwater on profitability. For their parts, green house growers will enhance gross profitability from 48% to 68% while indoor growers increase profitability from 47% to 61%.

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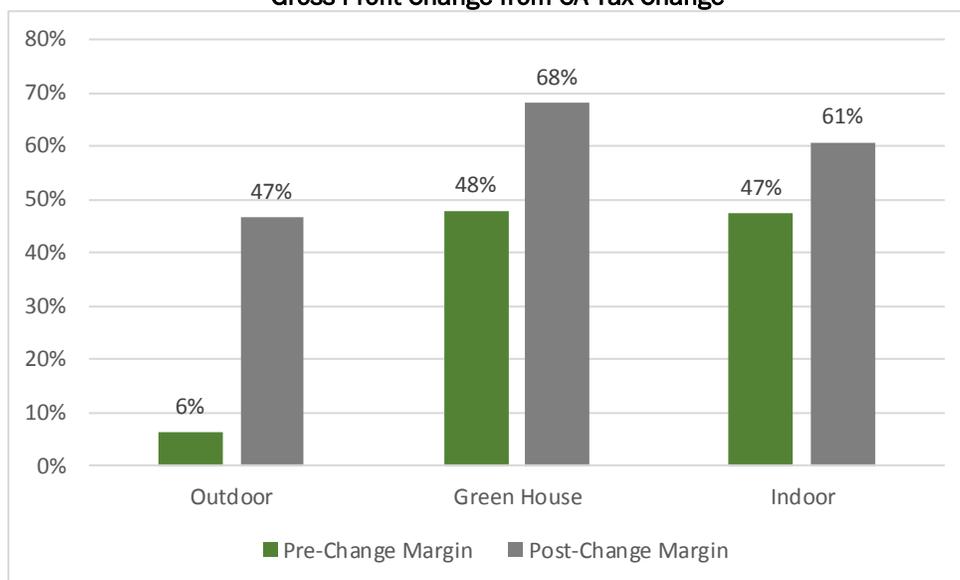
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Investment Highlights

- California flower cultivation tax to be eliminated.
- Wholesale prices remain challenging at roughly 15% of East Coast states but the tax change meaningfully lowers the breakeven threshold for cultivators and permits some breathing room on operations.
- Expect further consolidation as scale proves even more beneficial and market conditions promote MSOs to meaningfully enter the market.
- Stocks of CA exposed companies are disproportionately cheap. Expect outperforming stock returns in the near term in correction of the discount as conditions seem now tenable.
- Outdoor growers disproportionately benefit
- View biggest winners of tax change in our view are large CA cultivators including Glasshouse, Lowell Farms, Harborside, Parent Co and Planet 13.

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Gross Profit Change from CA Tax Change


Source: Viridian Capital Advisor Estimates, Cannabis Benchmarks

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			Count	Percent
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