IP Underpins Cannabis Business Value and Fuels Growth Opportunities

Cannabis Commoditization is Driving Companies to Differentiate through IP

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As cannabis becomes legal across the US and other countries, the black or gray markets of the past begin to fade away. However, cannabis remains a commodity. This in turn presents a unique opportunity for businesses to differentiate themselves through their IP. This commoditization of the cannabis industry has led to many new forms of cannabis and cannabis related products: edibles, CBD products, oils, creams, lighting/hydration systems, evolving growing techniques, and branded smoking products. Commoditization of cannabis calls for creativity in the development of intellectual property.

Branding is Imperative and IP Licensing is a Necessity

In the end, cannabis is still essentially an undifferentiated commodity product from the consumer's point of view. If competitive cannabis businesses want to create any amount of sustainable market share, they need to differentiate their products via branding, brand extension and licensing.

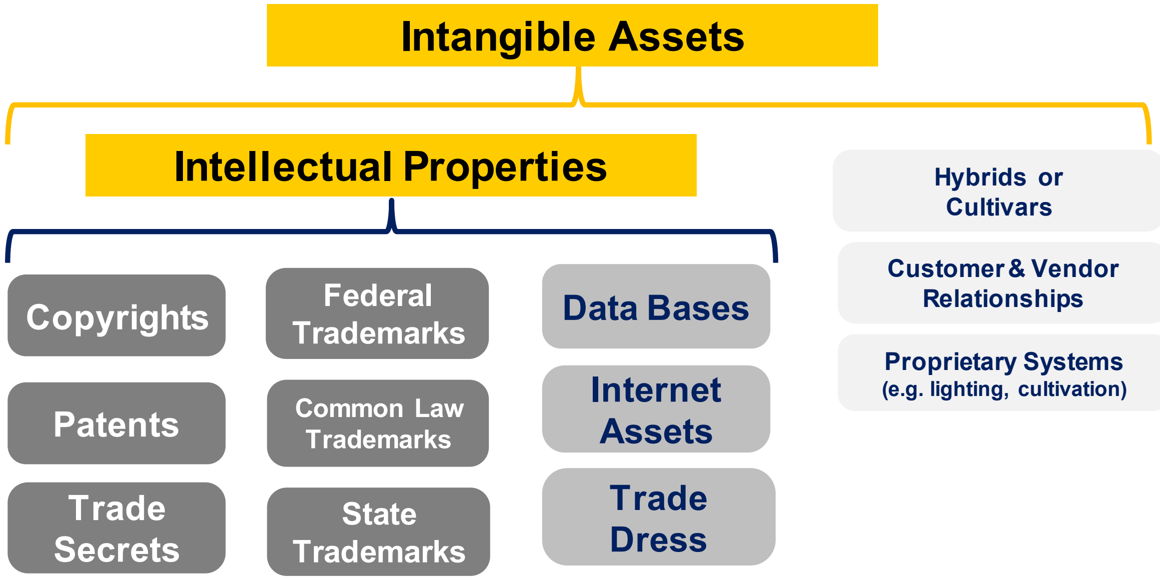
The primary blockade to brand building for cannabis in the US is the fact that you cannot register a federal trademark for cannabis; but you can apply a Common Law Trademark on cannabis product. Constructing a ring of federal trademarks circling the Common Law Trademark in order to build a cannabis brand via licensing is a solution.

The core of this brand building is to have your Common Law Trademarks on your actual cannabis product, and then use Federal Trademarks duplicative of the Common Law Trademark, licensed to third parties. Licensees can then manufacture products like apparel, smoking paraphernalia and leather goods, as well as offer services like health centers and social media sites.

Licensing and Valuing Intellectual Property

In addition to trademarks and brands, how else can a company differentiate itself? The figure below looks at various types of assets and intellectual properties: a wide range of assets that can be developed internally and/or via licensing, ranging from trade secrets to copyrights and from trade dress to cultivars and various growing systems.

Figure 1



It is not only trademarks and brands that can be licensed by companies that are IP-based. As you can see below, in Figure 2, we have broken this chart up into four broad categories of licensing methods, and within each are types of IP that can be licensed.

Figure 2. Licensing Cannabis IP

Licensing Method	Type of IP
Branding/Trademarks	Trademarks Trade Dress Graphics
Technology	Patents Trade Secrets
Process Licensing	Lab/Management Systems Technical Know-How
Genetics	Hybrids Cultivars

How to Value IP and IP Licenses

Thinking about the overview above, the question becomes: What if we do have IP within the company? How do we identify it, and more importantly, how do we value it? For example, how do we value trade secrets as opposed to patents -- or how do we value technical know-how, and how do we value complex systems that effectively run a lab testing facility.

We will explore the most accepted IP valuation methodologies in practice by looking at a case study of "Cannabis Corporation," in which a theoretical company has two bundles of assets that require valuation: a trademark/brand bundle and a trade secret/technical know-how bundle. In this case study, we are going to value the core IP within each bundle, as well as value what a single license agreement for each bundle would add to the company. A summary of Cannabis Corporation's IP and the methodologies being employed for valuation are below, in Figure 3.

Figure 3. Cannabis Corporation IP

Bundles/Types of IP	Valuation Methodology	IP Being Valued
Brand/Trademark	Income Approach	Core IP + 1 License
Trade Secret/Technical Know-How	Cost Approach	Core IP + 1 License

<u>Cannabis Corporation Case Study</u>

Cannabis Corporation is illustrative of a relatively well-established Oregon based company that has many products and lots of proprietary IP, and one whose licensing program is just getting started. The company wants to license the IP within each bundle to companies in Colorado and California. In order to value the company's two bundles of IP, as well as the incremental value of a single license for each, we must first consider the different Standard Valuation Methodologies: the income approach, the market approach, and the cost approach.

The income approach calculates the present value of future income streams specifically attributable to the IP asset. This method utilizes forecasted financial results based on factors such as historical financial results, industry trends, and the competitive environment.

The market approach values IP by comparing the subject asset to available comparable transactions involving similar assets with similar uses. This provides a reasonable indication of value if an active market exists that can provide examples of recent arm's-length transactions, with adequate information regarding terms and conditions.

Finally, the historical cost to develop an asset is sometimes used to determine its value. However, the cost to develop IP is rarely representative of its ultimate value. This approach is less useful for IP used in products that have reached the market and generated revenues. Generally, the cost approach is better suited for the analysis of IP and products that have not yet been developed commercially. Alternatively, the cost approach may be used for products and services that could be re-created quickly using current or future costs. It reflects the cost a company could avoid by purchasing, rather than duplicating, a similar development effort.

To determine the value of most IP, we must calculate the present value of the hypothetical revenue or royalty streams generated in each case, and we accomplish this by conducting a discounted cash flow ("DCF") analysis. A DCF analysis estimates the value of an investment based on its future free cash flows.

There are also a handful of assumptions for each of the methodologies employed that we rely upon to conduct our DCF analyses. Below, in Figure 4, is a list of the assumptions that we rely upon in our case study.

Figure 4. Valuation Assumptions

Income Approach Assumptions	
Allocation of Revenue to Trademark/Brand Bundle	10.0%
Trademark Remaining Useful Life (in years)	10 years
Short-Term Growth Rate (2018-2022)	31.6%
Long-Term Growth Rate (2023 and beyond)	3.2%
Cannabis Corp. Historical EBIT Margin	16.6%
Discount Rate (Weighted Avg. Cost of Capital)	20.1%
Cost Approach Assumptions	
Annual Lic. Fee Based on Current Costs - T.S./Know-How Bundle	$20,000/month
Trade Secret/Know-How - Remaining Useful Life (in years)	5

Valuing the Trademark/Brand Bundle

The first analysis that we will explore in detail is the trademark/brand bundle valuation. We are going to use the income approach to calculate the present value of the revenue generated by both the core IP and a single trademark/brand license.

The first step in our DCF analysis is to determine what amount of revenue Cannabis Corporation may generate in the future. We apply our short-term and long-term growth rates to Cannabis Corporation's most recent revenues and project them out 10 years into the future. While trademarks essentially have an indefinite lifespan (think about how long Coca-Cola has been and will be around), for the purpose of this analysis we have limited our projections to only 10 years.

Next, we apply Cannabis Corporation's historical average earnings before interest and taxes ("EBIT") margin to our projected revenues to calculate their annual free cash flows. We then use the company's weighted average cost of capital ("WACC") for our discount rate and apply it to each free cash flow period to determine the present value.

We need to allocate, or apportion, a percentage of the company's total present value to the trademark/brand bundle, and we accomplish this by using the market approach to calculate the average allocation of value for this specific type of IP. When public companies merge or acquire other companies, they are required to make disclosures regarding the nature of the transaction. By specifically disclosing the portion of the purchase price attributed to an acquired piece of intellectual property, we are given an estimate of its contribution to the overall value of the company.

A prior study analyzed what public companies allocate to trademarks and trade names, and the average was 10.0%. We apply that figure to the total present value of Cannabis

Corporation's free cash flows to arrive at the value of the company's trademark/brand bundle. Below, in Figure 5, is a summary of our trademark/brand bundle core IP analysis.

Figure 5

Trademark/Brand Bundle Core IP Valuation - Income Approach					
		2018	**2019**	**...**	**2027**
Revenue		$30,000,000	$39,480,000		$105,409,542
		x	x		x
EBIT Margin		*16.6%*	*16.6%*		*16.6%*
		=	=		=
EBIT		**$4,980,000**	**$6,553,680**	**...**	**$17,497,984**
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.19
		=	=		=
Present Value of Free Cash Flow		**$4,544,172**	**$5,456,776**	**...**	**$3,365,474**

Total PV of Cash Flow	**$53,018,523**
Allocation of Value to Trademark/Brand Bundle	10%
Value of Cannabis Corp.'s Trademark/Brand Bundle	**$5,301,852**

To determine the value that a single trademark/brand license would bring to the company, we incorporate the same approach as we did for valuing their core IP; however, there is no application of an EBIT margin because the revenue goes straight to the bottom line since no business operations created the income. Below, in Figure 6, is a summary of our trademark/brand license incremental value analysis.

Figure 6

Incremental Trademark/Brand Valuation - 1 License - Income Approach					
		2018	2019	...	2027
Revenue		$1,000,000	$2,000,000		$10,000,000
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.19
		=	=		=
Present Value of Free Cash Flow		**$912,491**	**$1,665,279**	**...**	**$1,923,592**

Total PV of Cash Flow	**$20,326,234**
Allocation of Value to Trademark/Brand Bundle	10%
Incremental Value of 1 Trademark/Brand License to Cannabis Corp.	**$2,032,623**

Valuing the Trade Secret/Technical Know-How Bundle

To value Cannabis Corporation's trade secret/technical know-how bundle, we are going to employ the cost approach. This valuation methodology reflects the cost that a company could avoid by purchasing, rather than duplicating, a similar development effort. As you will see in Figure 7, below, the IP within this bundle is comprised of software, facilities, data management, lab testing, and customer resource management.

Figure 7

Trade Secret/Know-How Valuation - Cost Approach	
	Annualized Cost
Software	$110,000
Facilities	$115,000
Data Management	$105,000
Lab Testing	$80,000
CRM	$40,000
Annuual Trade Secret/Know-How Value	**$450,000**

The annual trade secret/know-how value that the company will charge to license this IP is based on the time, labor, and other inputs necessary to maintain the system on an annual basis for the remainder of its useful life, which we have capped at five years. The actual valuation is very straightforward, even more so than the previous method; we apply the annual IP value to the entirety of its useful life, and then discount those amounts back to a present value. Below, in Figure 8, is a summary of our trade secret/technical know-how bundle core IP analysis.

Figure 8

Trade Secret/Technical Know-How Core IP Valuation - Cost Approach					
		2018	**2019**	**...**	**2022**
Annual Trade Secret/Know-How Value		$450,000	$450,000		$450,000
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.48
		=	=		=
Present Value of Free Cash Flow		**$410,621**	**$374,688**	**...**	**$216,292**

Value of Cannabis Corp.'s Trade Secrect/Technical Know-How Bundle	**$1,573,347**

If Cannabis Corporation were to license their system to a single user for $20,000 per month, the annual fee would be $240,000. Below, in Figure 9, is a summary of our trade secret/technical know-how license incremental value analysis.

Figure 9

Incremental Tade Secret/Technical Know-How Valuation - 1 License - Cost Approach					
		2018	**2019**	**...**	**2022**
Annual Trade Secret/Know-How Fee		$240,000	$240,000		$240,000
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.48
		=	=		=
Present Value of Free Cash Flow		**$218,998**	**$199,833**	**...**	**$115,356**

Incremental Value of 1 Trade Secret/Technical Know-How License to Cannabis Corp.	**$839,118**

Finally, below in Figure 10, is a summary of Cannabis Corporation's total core and incremental IP value.

Figure 10

Cannabis Corp.'s IP Valuation Overview	Core IP Value	Incremental IP Value
Income Approach: Trademark/Brand Bundle	$5,301,852	$2,032,623
Cost Approach: Trade Secret/Technical Know-How Bundle	$1,573,347	$839,118
Total Value:	**$6,875,199**	**$2,871,742**
Cannabis Corp.'s Total Core and Incremental IP Value:		**$9,746,941**

Summary of Cannabis Corporation's Value

As we have seen in our valuation examples of Cannabis Corporation's different IP bundles, IP is a great way to differentiate a business from its competitors. As cannabis becomes legal in more and more states across the country, the product itself is becoming more of a commodity and this presents great opportunities within the industry. With these opportunities comes the need for cannabis companies and professionals to understand the IP involved in all facets of their business and how to value it properly.

If you take away only one thing from this article, it is this: IP can have tremendous value and companies that understand how to value, monetize, and leverage their IP will succeed in differentiating themselves in an industry that is in its nascency.