

Legal or not, the pot business is still wacky

September 4 2014, by Jonathan Fahey



In this Aug. 25, 2014 photo, Kayvan Khalatbari, left, sits on the couch in the lobby of his medical and recreational marijuana store Denver Relief, as his employee Allison Woods escorts a customer into the shop, in Denver. Khalatbari also runs Denver Relief Consulting, which assists current and would-be marijuana-related businesses around the country, as well as owning a chain of pizza restaurants in Denver. (AP Photo/Brennan Linsley)

Legal or not, the business of selling weed in the U.S. is as wacky as ever.

The tangle of rules and regulations that govern whether and how it can

be grown, bought and sold create complexity and ambiguity that cause major headaches for marijuana businesses—and enticing opportunities for those who want to exploit it.

"It's a gray market industry, that's just how it is," says Kayvan Khalatbari, who owns a marijuana dispensary and a chain of pizza restaurants in Denver.

The big issue: the nation hasn't decided whether marijuana is a dangerous illegal drug or not much worse than tobacco or alcohol. According to federal law, it is an illegal narcotic like heroin, with "no currently accepted medical use." But recent legalization pushes have made it legal—for medical use—in 23 states and Washington D.C. In Colorado and Washington State, it can be bought just for fun.

Entrepreneurs and investors have to navigate laws that are different from state to state and sometimes from county to county. That has given rise to a bumper crop of consultants promising to show the way to success, while shady public companies spin visions of fat profits. Consumers now have an array of new [pot](#)-related products to choose from, many of far higher quality than what's offered on the corner. But they must also discern truth from hope in the many claims about all the supposedly wonderful things pot can do.

ENTREPRENEURS

Khalatbari started his first pizza restaurant with a small business loan from a bank. To raise money to build a marijuana-growing facility, a bank loan wasn't an option.

Almost all banks avoid working with pot businesses because pot is illegal federally, and banks want to avoid running afoul of anti-trafficking laws. Also, residency restrictions in Colorado prevent raising money from out-

of-state investors in exchange for a share of the company, which is exactly what most investors want.

So, to build a 40,000 square-foot growing facility, Khalatbari teamed with an out-of-state investor who is lending money for construction while trying to establish residency in Colorado. When that comes through, the investor should get an ownership stake in the facility.

Khalatbari says there's plenty of investor money sloshing around, looking to fund marijuana businesses, but the terms are expensive because of the risk and the restrictions.

"It's almost impossible not to get funding," he says, "but it's not going to be on the terms you want."

Once up and running, entrepreneurs face more twists. Khalatbari kept his bank account in the name of the management company that controlled his pizza restaurants, called Sexy Pizza, along with his marijuana dispensary, Denver Relief. (He is also a stand-up comedy promoter.)

He was careful not to pay pot-related vendors out of the account, instead using cash, which is common in the pot business. And he didn't make cash deposits over \$10,000 in order to avoid triggering suspicious activity inquiries. Still, three successive banks dropped him after learning the management company had ties to pot.

"We can't be honest and open about where we can put our legal money," he says. "They are pushing us underground."

He has recently found an unidentified bank that will work with him and a few other pot businesses.

Khalatbari can't write off certain expenses the way most businesses can. The Internal Revenue Service prohibits deductions for expenses incurred while selling what the federal government considers to be an illegal drug. That makes his profit lower than it otherwise would be. It also encourages him and other sellers to designate, for tax purposes, only a small portion of their stores as having anything to do with selling pot.

These conditions can help a business flourish once it's open, however. Would-be competitors face the same hurdles to getting started—local zoning rules, state regulations, financing complexity or a slow bureaucracy—so it can often be some time before the established business faces a real challenge.

California rules are relatively lax, and there are believed to be at least 500 dispensaries just in Los Angeles. But Connecticut has approved only six dispensaries. The first opened last month—without pot—two years after getting approval. Illinois growing facilities must put up a \$2 million surety bond to get approval. Washington has awarded 43 licenses to sell marijuana for recreational use—and just one in Seattle, called Cannabis City.

Khalatbari has plenty of competition, but the profit margin at his marijuana dispensary is 60 percent higher than at the pizza restaurants. Even after the legal headaches, it's easier to make a profit selling the bud of a plant for \$200 an ounce than it is selling a meat lover's pizza (pepperoni, spicy sausage, Canadian bacon and mozzarella) for \$19.99.



In this Aug. 25, 2014 photo, marijuana store Denver Relief co-owner Kayvan Khalatbari, right, talks with his employee Jeff Botkin his medical and recreational marijuana shop in Denver. Khalatbari also runs Denver Relief Consulting, which assists current and would-be marijuana-related businesses around the country, as well as owning a chain of pizza restaurants in Denver. (AP Photo/Brennan Linsley)

"It's much higher-risk," he says of the marijuana business. "But the reward is much greater."

CONSULTANTS

"Everyone wants to be in the weed business," says Adam Bierman, managing partner at a marijuana consulting company based in Culver City, California, called the Med Men.

That suits Bierman just fine. Dozens if not hundreds of consultants like

Bierman have popped up, feeding off the complexity of the marijuana business and the desire of so many to make it big in pot. Some act as matchmakers, promising to connect investors with entrepreneurs looking for money. Others sell help navigating the licensing process, tips on how best to grow marijuana, or advice about how to manage a startup that must operate outside of the banking system.

But many of these "consultants" have little or no experience in the business. Bierman acknowledges he didn't when he started six years ago. "We got our teeth kicked in," he says.

Now his firm knows the ropes, he says, but the industry is crawling with people who don't.

"There are a lot of opportunistic people coming into this industry from every angle," he says. "And unfortunately we are part of that. We are one of the companies I'm blasting, and I hate that."

In February, PetroTech Oil and Gas—a drilling services company—announced it was establishing a management company in Colorado and Washington to help pot growers. Trading volume in the tiny company's stock rose 13-fold and the penny stock rose to 7 cents per share over three weeks. The Securities and Exchange Commission suspended trading in the stock in March over questions about the accuracy of the information about the company's operations.

INVESTORS

Investing in the pot business seems like it should be as easy as printing money. The product's millions of users are so dedicated that they've been willing to risk arrest to get it. To reach them, all businesses have to do is grow a weed and sell the flowers.

Pot investing is treacherous, though, even for professionals.

"There are a lot of large egos and puffery in this industry," says Brendan Kennedy, a former Silicon Valley banker who helped found Privateer Holdings, a marijuana-focused private equity firm. "It takes a lot of time and energy to sort through the hyperbole and find the right, legitimate opportunities."

Every new pot company thinks it has the best growing technique or marijuana strain, Kennedy says, but few have worked out a long-term business plan that coldly assesses the market and the risks. Growing plants for profit isn't quite so simple.

"Ultimately it's a crop, it's a commodity, not very different from a lot of agricultural products that are out there," Kennedy says. "Would you invest in a winery? Or a strawberry grower?"

Investing in pot stocks is even scarier, because nearly all of them are so-called penny stocks, like PetroTech, that trade outside of major exchanges. There are now a couple dozen of these companies, often with names that play on marijuana's scientific name, *cannabis sativa*, such as Advanced Cannabis Solutions or Cannabusiness Group. But many have tenuous ties to the marijuana industry, regulators say.



In this Aug. 25, 2014 photo, customers check in at marijuana store Denver Relief in Denver. Store co-owner Kayvan Khalatbari also runs Denver Relief Consulting, which assists current and would-be marijuana-related businesses around the country, as well as owning a chain of pizza restaurants in Denver. (AP Photo/Brennan Linsley)

Canadian regulators issued a warning about marijuana-related stocks in June, following similar alerts from the U.S. Financial Industry Regulatory Authority last year and one from the SEC in May. Five times this year the SEC has suspended trading in shares of companies claiming to be in the marijuana business.

Kennedy says the penny stock companies "are full of charlatans and hucksters," who are "purely playing on the desire of Main Street investors to get into the industry."

One of the companies, called GrowLife, makes urban gardening

equipment and trades under the ticker symbol PHOT. An October report designed to look like it was issued by a Wall Street firm suggested the company's stock was poised to rise nearly 300 percent. But that "research" was actually paid for by GrowLife—a detail found only in the report's fine print.

GrowLife's shares soared 900 percent, to 60 cents from 6 cents, between October and early April, when trading was halted by the SEC. In June the company revealed that the \$37 million loss it reported for the first quarter was actually double that, \$74 million. GrowLife shares have since fallen back to 7 cents.

GrowLife CEO Marco Hegyi says the report "was never intended to boost the stock" and that legalization efforts boosted shares of GrowLife and other marijuana companies. Hegyi, who became CEO in March, says the company is working to improve its financial reporting. "We're more on top of our business," he says.

CONSUMERS

A decade ago, pot consumers risked jail time by buying pot of uncertain origin and quality in back-alley deals. Now, in many states, they can shop openly for a wide variety of strains with different levels of potency. Pot can be bought in lotions, foods and drinks with precise doses.



In this Aug. 25, 2014 photo, Kayvan Khalatbari works at his desk at his consulting firm Denver Relief Consulting, which sits above a marijuana store which he co-owns, in Denver. Denver Relief Consulting assists current and would-be marijuana-related businesses around the country, as well as owning a chain of pizza restaurants in Denver. (AP Photo/Brennan Linsley)

But buyers still need to beware. Companies are using pot's new legitimacy to try to equate getting high with taking care of your body or curing any number of ailments, making extraordinary health claims about pot to push their products.

"Because it's a drug that makes people feel good, marketers want to put medical claims on it," says Bill London, a professor of public health at California State University in Los Angeles and a health claim watchdog. London has no problem with legalization, but says many medical claims for marijuana "are false or exaggerated" and "should not be tolerated."

The website Cannabis.org, which is owned by GrowLife and carries the tagline "Cannabis is Medicine," lists 17 major diseases that cannabis can treat, including Alzheimer's, cancer, and diabetes.

Some of the chemicals in marijuana have been tested thoroughly and found to effectively treat some conditions, such as reducing nausea and stimulating appetite in patients undergoing chemotherapy. These or other chemicals in pot may someday be found to be effective in treating other diseases—or they could be found to be dangerous in ways not yet understood. Scientists simply don't know yet.



In this Aug. 25, 2014 photo, marijuana store co-owner Kayvan Khalatbari, center, photographs a product label inside the front office of the marijuana shop Denver Relief, in Denver. Khalatbari also runs Denver Relief Consulting, which assists current and would-be marijuana-related businesses around the country, as well as owning a chain of pizza restaurants in Denver. (AP Photo/Brennan Linsley)

A Colorado company called Dixie Elixirs sells pot in pill form called "scrips"—short for "prescription." These pills allow users to manage both their ups and downs, despite the same amount of pot in each pill, with additives like ashwagandha root. "Awakening Scrips" are said to provide a "stimulating sensation," while "Relaxing Scrips" are said to "reduce mental and physical stress and promote relaxation."

Joe Hodas, chief marketing officer at Dixie Elixirs, says the company is careful to not make specific medical claims about its products. "It's the regulatory framework that forces businesses to sell ([marijuana](#)) as medicine because that's the only way it's legal (in most states)," he says.

In a marketing pitch for one pot-based product, called Foria, a woman identified as "Anna, 29" says: "Foria is potent medicine and the most healing way I have ever used cannabis." It's not clear that Anna had a medical problem, though. The product is a pot-based lubricant for women, designed to increase sexual pleasure by delivering a high through their private parts.

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