



# CANNABIS 2.0: INVESTING IN TODAY'S REGULATED INDUSTRY

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## Cannabis 2.0: Investing in Today's Regulated Industry

### Executive Summary

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In 2012 Colorado and Washington State pioneered the legalization of adult-use cannabis at a time when federal cannabis legalization was still a farfetched concept. Fast forward — as of October 2022, a total of 37 states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands regulate cannabis for medical use by qualified individuals, and 19 states have legalized adult-use cannabis. As a result, two-thirds of Americans now have legal access to cannabis for either medical or recreational/adult use purposes. Although some political obstacles remain, it now appears more inevitable than ever that a lift of federal prohibition of cannabis is only a matter of time. Momentum among the general public as well as in both U.S. political parties continues to move in favor of legalization with 69 percent of Americans backing adult-use legalization, according to an [April 2022 survey](#) conducted by market research firm SSRS.

There have been numerous other indicators over the past several years that demonstrate how acceptance of cannabis has reached a tipping point. At the start of the coronavirus pandemic in spring 2020, cannabis companies were declared to be essential businesses in most states with regulated markets, just as many new markets were opening, or preparing to open. Overall sales of cannabis surged during the pandemic, as more consumers began to recognize how it could address their health and wellness needs. It seems apparent that cannabis stigmatization is on the decline. For example, on the investment front we are seeing a far broader range of investors interested in the space, including institutional investors who have actively been educating themselves on the cannabis sector over the past several years, and we are seeing those institutional investors jumping into the space. We estimate that we have seen about double the level of interest from institutional investors in 2022 as in previous years. In addition, the firm continues to see an increasing number of inquiries from companies seeking capital.

Finally, we have witnessed slow but steady progress toward federal legalization. There have been multiple bills introduced from members of both political parties in the House of Representatives that address federal legalization. In July 2022, the House once again passed the SAFE Banking Act. Jefferies analyst Owen Bennett noted on Sep. 16th 2022 that many in the industry feel optimistic about SAFE's chances in the Senate.

*“On a positive note, while not overwhelming, there was a broad consensus among MSOs we spoke to (say 65/35) on SAFE+ passing, likely in the lame duck, and likely part of another package, probably the NDAA (National Defense Authorization Act). The view is it will be the current SAFE language with a number of social equity provisions added, most notably the HOPE Act.”*

And for the first time in the U.S. Senate, Majority Leader Chuck Schumer in July introduced the Cannabis Administration and Opportunity Act, which would decriminalize cannabis on the federal level and allow states to set their own marijuana laws without fear of punishment from Washington.

In this white paper, we analyze the rapid expansion of the U.S. cannabis market over the past several years and explain why we continue to believe it is one of the most attractive investment opportunities of our generation. We identify the characteristics of the U.S. cannabis market and the unique advantages of investment in U.S. cannabis companies as compared to other alternative investments. We have concluded that given the projected growth of the cannabis industry, the existing large funding gap in the cannabis market and the apparent inevitability of federal legalization, investors in cannabis businesses today will have the opportunity to achieve superior risk-adjusted returns compared to other asset classes.

## Section 1: Cannabis 101

### Ancillary vs. Plant-touching Businesses

Cannabis investors typically bifurcate the landscape into ancillary and plant-touching companies. Ancillary businesses typically derive the majority of revenues from licensed cannabis operators, but do not themselves require a cannabis license to operate. This includes software, business services, biotech, and specialty finance companies.

Plant-touching businesses, on the other hand, require a cannabis license to operate. These include dispensaries, cultivators, distributors, branded products, and vertically integrated players (e.g., operators that handle the plant from seed-to-sale). Plant-touching businesses are typically more capital intensive vs. ancillary businesses and have a higher cost of capital relative to ancillary businesses. This higher cost of capital is driven by the fact that some investors will invest in ancillary cannabis businesses but not plant-touching cannabis businesses due to higher perceived risk. At KEY Investment Partners, we see attractive opportunities across both ancillary and plant-touching cannabis businesses.

#### THE CANNABIS ECOSYSTEM (PLANT & NON-PLANT TOUCHING)

### ANCILLARY

- |   |   |   |
|---|---|---|
| <b>Technology</b> <ul style="list-style-type: none"> <li>• B2B and DTC Services</li> <li>• Payment Solutions</li> <li>• Marketplaces</li> <li>• SaaS Focused</li> </ul> | <b>Business Services</b> <ul style="list-style-type: none"> <li>• Data Analytics</li> <li>• HR and Payroll Compliance</li> <li>• Compliance Services</li> <li>• Specialty Finance</li> <li>• Loyalty</li> </ul> | <b>Biotech</b> <ul style="list-style-type: none"> <li>• Testing Labs</li> <li>• Agriculture Science</li> <li>• Medicinal Applications</li> <li>• Bioavailability</li> </ul> |
|---|---|---|

### PLANT TOUCHING

- |  |   |   |
|--|---|---|
| <b>Brands</b> <ul style="list-style-type: none"> <li>• Edibles</li> <li>• Beverages</li> <li>• Vapes</li> <li>• Premium &amp; Wholesale</li> </ul> | <b>Business Services</b> <ul style="list-style-type: none"> <li>• Distribution &amp; Logistics</li> <li>• License Application</li> <li>• Extraction Services</li> </ul> | <b>Vertically Integrated</b> <ul style="list-style-type: none"> <li>• Single &amp; Multi-state Operatoes</li> <li>• Limited License States</li> </ul> |
|--|---|---|

## Single-state versus Multi-state Operator, U.S. MSO versus Canadian LP

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For U.S. plant-touching operators, cannabis investors typically categorize businesses as either single-state operators (SSO) or multi-state operators (MSOs). Because cannabis remains federally illegal, MSOs are required to replicate their full supply chain in each state in which they operate because moving product across state lines would be a violation of federal law.

Because cannabis remains federally illegal in the United States, SSOs and MSOs have not yet been permitted to list publicly on major U.S. exchanges (NYSE and NASDAQ). Therefore, the publicly listed U.S. plant-touching companies today (e.g., Cresco Labs, GTI, Trulieve) are mostly listed on the Canadian Securities Exchange (CSE). This exchange has limited institutional investors today (est. <2% of cannabis company float) due to technical restrictions for most institutions. This in turn drives less trading volume for CSE-listed companies.

On the other hand, because Canada legalized cannabis federally in 2018, Canadian-domiciled licensed producers (LPs) like Canopy Growth and Tilray are able to access major U.S. exchanges. As such, Canadian players typically have higher trading volumes, more institutional investors, and lower cost of capital. That said, we believe the U.S. market opportunity presents a much larger, more attractive addressable market. Further, we expect significant valuation uplift is baked into U.S. operators today, as legislation that permits them to uplist to the NASDAQ/NYSE would inherently attract more institutional investors. Therefore, at KEY we have chosen to focus on U.S. cannabis opportunities over Canadian ones today.

## Hemp vs. Marijuana

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One of the most important and frequently misunderstood distinctions in the cannabis industry is that of hemp versus marijuana. Semantically, hemp refers to cannabis bred for a variety of commercial items and industrial uses, including paper, clothing, biodegradable plastics and biofuel. Marijuana, on the other hand, refers to cannabis strains bred for the potent, resinous glands that grow on the flowers and leaves.

From a legal perspective, the distinction is much more complicated. The delineation is based on the levels of the two most commonly known cannabinoids: CBD and delta-9 tetrahydrocannabinol (THC). CBD is the non-psychoactive cannabinoid that has been shown to lessen the psychoactive components of THC and provide significant medical benefits. THC, on the other hand, is the psychoactive cannabinoid that creates an intoxicating effect.

The generally accepted, international definition of hemp refers to cannabis strains with less than 0.3% THC by weight, levels so low that no one could get high from smoking it. Moreover, since industrial hemp is high in CBD, THC's psychoactive effects are counteracted to a certain degree in the plant. Despite this fact, since 2001 until recently, the Drug Enforcement Agency (DEA) had banned all products sourced from hemp containing any trace amount of THC. As such, in the United States there had been no legal distinction between hemp and marijuana, and 98% of DEA-destroyed cannabis is hemp (by definition), which, as stated above, has no ability to get consumers high and could instead be used for a variety of industrial purposes. In an influential turn of events in September of 2018, the Food and Drug Administration (FDA) approved and the DEA subsequently rescheduled [Epidiolex](#), a CBD-based medicine used for treatment of patients with certain forms of epilepsy.

## HEMP VERSUS MARIJUANA FLOWER

While Hemp and marijuana are both part of the cannabis species, each has unique properties that distinguish its use.

### Hemp

- Can grow as high as 20 feet, with leaves bunched near the top of the stem.
- Contains 0.3% or less of tetrahydrocannabinol(THC).
- No psychoactive properties.
- Can grow in most climates, bunched together with other plants; requires little care.



### Marijuana

- Shorter, resembles a bush, with more leaves and buds.
- Contains 5% - 35% THC.
- Psychoactive side effects.
- Growth is carefully monitored, controlled in an isolated, warm, humid area to maximize psychoactive uses. Cross-pollination can ruin THC content.



That brings us to the [Farm Bill](#), passed by the U.S. Senate and the House of Representatives in December of 2018. Once President Trump signed the bill into law, the bill decriminalized hemp nationwide. The bill disaggregated the legal definition of hemp from marijuana and redefines hemp as cannabis with less than 0.3% THC. Additionally, it allowed hemp farmers to use the U.S. banking system and to ship their product across state lines. The move was a giant leap in creating a legal market for hemp farmers nationwide.

However, growth of the hemp and hemp-derived CBD industry did not mature as quickly as expected following the farm bill's passage. Once legalized, CBD became a federally regulated substance, and the FDA has not yet issued guidance as to which products can include CBD or how those products can be marketed. The uncertainty of the FDA's position led big retailers unable to carry the products, and many companies reluctant to develop and manufacture CBD-related products.

With the upcoming expiration of the 2018 Farm Bill next year, lawmakers and stakeholders have highlighted reforms they hope to include in the 2023 Farm Bill to reshape and improve the hemp industry. One of the main goals of this legislation will be to finally unravel the FDA's position on hemp, which would in-turn drive the broader hemp market's development.

## Dispensary products

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People consume cannabis and its medicinal compounds, called cannabinoids, for both medical and recreational purposes. As stated in the previous section, the two most well-known cannabinoids are THC (delta-9 tetrahydrocannabinol) and CBD (cannabidiol). They have different effects, most notably that THC has a psychoactive effect, while CBD does not. Every product on a dispensary shelf today will contain varying levels of both CBD and THC and will induce a different effect when ingested:

- **Psychoactive:** High THC, low CBD (e.g., 10-30% THC, trace amounts of CBD)
- **Less psychoactive:** Balanced CBD/THC (e.g., 5-15% THC and CBD)
- **Non Psychoactive:** High CBD, low THC (e.g., 5-20% CBD, trace amounts of THC)

Products with high CBD and low THC amounts generally reduce anxiety, control pain/inflammation and leave the consumer functional. Products with high THC and low CBD generally have a more euphoric effect that leaves the consumer high.

Over the last several years, the introduction of “minor” cannabinoids has enabled product developers to create new kinds of cannabis products designed to produce specific effects to induce sleep, suppress appetite, calm anxiety or tackle other specific ailments. The term “minor cannabinoids” is used as a catch-all term for cannabinoids that are less common in raw cannabis and hemp, such as CBN, CBG, and CBC. These products are beginning to expand the definition of how cannabis can be utilized and are most prevalent among edibles which appeal to a broader spectrum of consumers.

When thinking about how to invest in the cannabis market, it is important to become familiar with the types of products offered in dispensaries, as these products will drive the growth of the entire ecosystem of cannabis businesses going forward. The below list highlights the different types of products a customer is likely to see when walking into a dispensary today:

- **Flower:** The traditional marijuana flower buds are cut, dried and cured for consistency and consumption. The flower is often rolled into joints or smoked out of glass pipes.
- **Pre-rolls:** Pre-rolls are simply joints that have already been rolled before they are sold. They come in a wide variety of different strains.
- **Concentrates:** Concentrates are highly potent cannabis extracts. They come in a variety of forms, including wax, shatter, hash and resin, that are quite strong and require the use of special equipment to burn. Concentrates are generally smoked by heavier marijuana users.

- **Vaporizers:** The most common vaporizers are battery-powered, pen-shaped devices that are more discreet than other methods of smoking. They are usually odorless and portable, and the device vaporizes marijuana oil (out of a cartridge), releasing the active compounds and leaving behind the contaminants found in smoke. Because no combustion takes place, inhaling from a vaporizer is not as harsh on the throat and lungs due to the lower temperature of the smoke.
- **Edibles:** Edibles are a method of consuming marijuana without inhalation. Generally, edibles are easier to dose and are discreet. They come in the form of gummy candy, chocolate, beverages or capsules with pre-measured amounts of THC, CBD and/or other minor cannabinoids. Edibles generally have stronger effects than smoking but take longer to enter the bloodstream since digestion is required.
- **Topicals:** Topicals are balms, lotions, creams, sprays, patches and bath products used solely for external application on the skin. Generally, topicals are nonpsychoactive and are good for consumers who prefer a high-CBD and low-THC product, usually for pain relief on a specific area of the body.
- **Drops (tinctures):** Drops are concentrated cannabis-infused products known as tinctures. If a user does not want to smoke or prefers a low-calorie alternative to edibles, drops are a good option.

## Medical marijuana

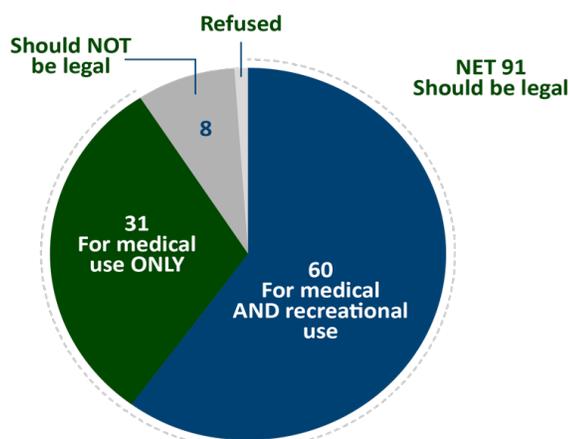
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While many consumers consume cannabis recreationally, what separates the cannabis market from other comparable markets like beer, wine or tobacco is that cannabis is believed by many to have medicinal applications.

**A 2021 PEW RESEARCH SURVEY REVEALED  
THAT 91% OF AMERICANS BACK LEGALIZING  
CANNABIS FOR EITHER MEDICAL AND/OR ADULT USE.**

Unfortunately, up to this point, there has been limited clinical research conducted around the medicinal uses of cannabis because the federal government currently classifies it as a Schedule I substance, which makes researching the plant extremely difficult. For someone to conduct research on a Schedule I drug in the United States, three federal agencies must approve the study before it moves forward to a clinical trial: the DEA, the FDA and the National Institute on Drug Abuse. After a study is conducted, for cannabis to be approved for medicinal use, there must be at least one randomized, double-blind, placebo-controlled clinical trial that proves cannabis is effective in treating a specific medical condition.

## FEWER THAN 10% OF U.S. ADULTS SAY MARIJUANA SHOULD NOT BE LEGAL AT ALL



Source: Survey of U.S. adults conducted April 5-11, 2021

Despite the limited research, there have been studies that demonstrated cannabis may have a therapeutic effect in specific areas. In 2017, the National Academy of Sciences, Engineering, and Medicine released its [report](#) on The Health Effects of Cannabis and Cannabinoids. After reviewing more than 10,000 peer-reviewed journals the report concluded:

- There is conclusive evidence that cannabis or cannabinoids are effective at treating chronic pain in adults and chemotherapy induced nausea and vomiting.
- There is moderate evidence that cannabis or cannabinoids are effective at improving short term sleep disturbances and limited evidence at improving appetite and decreasing weight loss.

Overall, there have been multiple studies suggesting that THC, the psychoactive/impairing component of cannabis, can be effective in the treatment of nausea, pain, appetite loss, insomnia, anxiety and inflammation. Ailments that are commonly treated with cannabis include chronic pain, multiple sclerosis, epilepsy, Parkinson's Disease, post-traumatic stress disorder (PTSD) and anorexia/nausea/weight loss.

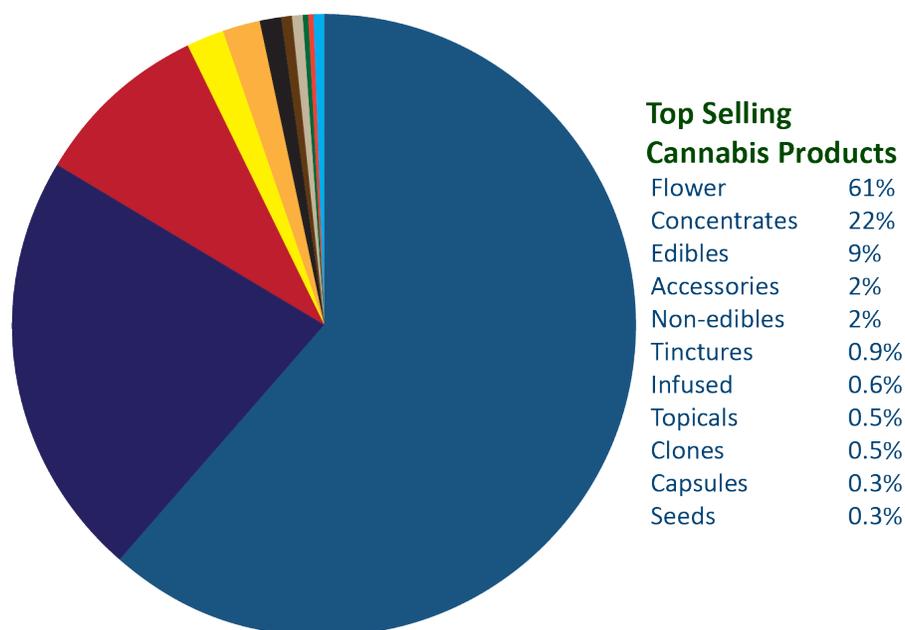
Interestingly, the reason cannabinoids have so many potential medical uses is because they have a similar chemical makeup to the chemicals the human body naturally produces that are involved in memory, appetite, movement and pain. Once the lift of federal prohibition occurs, institutions will no longer be required to receive DEA approval to perform clinical studies. This will open the door to medical marijuana funding and enable proper research of the plant. Until this funding is available, it remains hard to estimate exactly how large the medical cannabis market could grow.

In our opinion, given that only a handful of over 113 identified active cannabinoids are discussed today, it is reasonable to assume at least some additional medical uses will be discovered once studies can be commissioned freely. We believe that a pharmaceutical-based ecosystem for medicines with cannabis will develop over the coming years, but view this to be a medium-to-long-term opportunity. As such, the KEY team has chosen to focus on the immediate-term opportunities in medical and adult-use state-level programs.

## Section 2: The Growth of Regulated Cannabis Markets and Shifting U.S. Politics

According to market research firm BDS Analytics (BDSA), legal cannabis sales across the United States saw brisk growth in 2021, growing roughly 30% over the annual legal sales total from 2020. The firm projects that U.S. legal cannabis sales will surpass \$28 billion by the end of 2022 and will reach \$46 billion in 2026. California is expected to lead this growth, contributing an expected \$2.8 billion by 2026. Additional states that BDSA expects will drive growth include New York (+2.7 billion), New Jersey (+2.0 billion), Florida (+1.6 billion) and Michigan (+1 billion).

Share of sales by category across the United States are expected to stay relatively stable, with inhalables, and flower in particular, expected to remain the dominant category by share of dollar sales out to 2026. That said, one trend that we typically see as markets mature is that the share of flower sales declines over time from ~60 to ~40% (while growing in total \$ sales). That flower market share is typically gained by concentrates and edibles, which we believe demonstrates that many new consumers in legal markets prefer healthier alternatives to smoking combustible flower. This preference for non-flower alternatives may also reflect a continuation of the stigma associated with cannabis as a legacy from the War on Drugs.



The ongoing expansion of new markets in the United States, combined with growing consumer engagement with cannabis products and the increasing number of products available will continue to propel growth of the industry well into the next decade. North America will continue to dominate the vast majority of legal spending as more U.S. states transition from medical only (limited patient pool) to adult use (all adults over age 21). In 2018 legal cannabis spending in North America was estimated to be around 95% of total global spending. By combining an analysis of historical trends with their forecast for the future, BDS Analytics indicates that the cannabis market is slated for massive growth over the next six-plus years. In addition, BDSA predicts that adult-use spending will be the primary force pushing the growth of the industry. Adult-use sales were 56% of total sales in 2018; BDSA expects this number to grow to 66% of total sales by 2024.

## U.S. adult-use market snapshot

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The legal U.S. adult-use markets continue to generate large amounts of revenue, a trend that we expect to continue over the next six-plus years. Meanwhile, the progress of state-by-state legalization whether for recreational or medical marijuana continues to march forward. Since 2019, 10 states have legalized adult-use cannabis, including Arizona, Connecticut, Illinois, Montana, New Jersey, New Mexico, New York, Rhode Island, Vermont and Virginia. In addition, states expecting to legalize adult-use cannabis in 2022 include Delaware, Maryland, Minnesota, Missouri, New Hampshire and Ohio. According to BDSA, legal cannabis sales in the United States will surpass \$28 billion in 2022, a growth of ~20% over 2021. In addition, BDSA forecasts that U.S. sales will reach ~\$46 billion in 2026.

## The politics of cannabis

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Despite the watershed moment of Senate Majority leader Chuck Schumer placing the full backing of his office behind cannabis legalization, midterm-election-year politics doomed any real federal legislative progress in 2022. However, that does not mean all is lost. Policymakers of all political leanings are seeing the writing on the wall: The voting public is overwhelmingly backing the legalization of cannabis and demonstrated business success in regulated markets is generating increased investment and enthusiasm. Legislators are recognizing that the time is fast arriving to provide clear and defined guidance on banking issues from the federal government, which will help equalize business conditions for the cannabis industry with every other thriving, regulated industry. Once federal legislation is finalized, those businesses already established will be in enviable positions for further growth.

One aspect that is working in the industry's political favor is the tremendous job growth cannabis has witnessed in recent years. In January 2022, U.S. employment in the cannabis industry stood at nearly 429,000 full-time jobs and growing, according to [Leafly](#). Even as the country went through the second year of the pandemic, the sector saw a 33% increase in new careers, creating more than 107,000 jobs thus far in 2022. That's about 280 new jobs per day.

## Section 3: The Public Cannabis Markets Today

### Public cannabis stocks listed on U.S. exchanges are undervalued due to lack of institutional investors

Because U.S. plant-touching businesses are unable to list on U.S. Exchanges (NASDAQ, NYSE), they have lower liquidity, trading volume and institutional investor ownership. We estimate that less than 2% of CSE/NEO-listed cannabis securities floats are held by institutional investors.

This limited institutional investor ownership depresses the valuations of public cannabis stocks relative to alcohol and tobacco stocks, despite much higher growth rates. These lower valuations on the public markets in-turn result in highly attractive private market valuations for cannabis companies. We therefore believe cannabis presents one of the most attractive investment sectors from a risk-adjusted return basis today.

## PUBLIC MARKET SECTOR COMPARISON

Company	Exchange	Ticker	Stock Price	Market Cap. (m)	YoY Sales Growth	P/Sales		EV/EBITDA	
						FY'21	FY'22E	FY'21	FY'22E
<b>US Cannabis MSOs</b>									
Curaleaf	CSE	CURA	CAD 7.52	3,970	16.7%	3.3x	2.8x	22.6x	13.0x
Trulieve	CSE	TRUL	CAD 16.72	2,400	42.9%	2.6x	1.8x	8.0x	6.7x
Green Thumb Industries	CSE	GTII	CAD 13.25	2,380	14.4%	2.7x	2.3x	8.9x	8.9x
Verano Holdings	CSE	VRNO	CAD 6.86	1,650	27.6%	2.2x	1.8x	9.1x	5.1x
Cresco Labs	CSE	CL	CAD 4.52	1,020	10.5%	1.2x	1.1x	8.0x	6.8x
<b>Median</b>				<b>\$ 2,380</b>	<b>14.4%</b>	<b>2.6x</b>	<b>1.8x</b>	<b>8.9x</b>	<b>6.8x</b>

Source: Pitchbook as of 8/10/22

Company	Exchange	Ticker	Stock Price	Market Cap. (m)	YoY Sales Growth	P/Sales		EV/EBITDA	
						FY'21	FY'22E	FY'21	FY'22E
<b>Alcohol &amp; Tobacco</b>									
Annheuser-Busch	NYSE	BUD	\$ 54.95	107,830	8.1%	2.0x	1.8x	10.2x	9.7x
Constellation Brands	NYSE	STZ	\$ 242.17	44,530	2.4%	5.2x	5.0x	21.9x	16.6x
Molson Coors	NYSE	TAP	\$ 55.73	11,860	4.2%	1.2x	1.1x	8.7x	8.9x
Phillip Morris	NYSE	PM	\$ 98.07	151,360	-6.8%	4.8x	5.2x	12.3x	13.1x
Altria Group	NYSE	MO	\$ 44.75	79,630	-1.2%	3.8x	3.8x	17.4x	8.3x
<b>Median</b>				<b>\$ 79,630</b>	<b>-1.2%</b>	<b>3.8x</b>	<b>3.8x</b>	<b>12.3x</b>	<b>9.7x</b>

Source: Pitchbook as of 8/10/22

Higher Cannabis Sales Growth Rate		1560bps
Cannabis Valuation Discount	53.1%	29.7%

## Section 4: Unique Characteristics of the Cannabis Industry as an Investment Opportunity

There are several unique characteristics of cannabis companies and the U.S. cannabis market that make investments in the space attractive today.

- 1. The global cannabis market has an embedded illicit market demand of approximately \$90 billion.** In an emerging market, an investor typically spends a significant amount of time estimating the total addressable market for the product or service a target company provides. Even with thorough analysis, it is difficult to evaluate how large an emerging market will grow to maturity. Unique to the cannabis industry is the fact that there is a relatively good idea of the demand for the product since the plant has existed in the illegal market for the past 100 or so years. Understanding the total embedded demand in the market de-risks cannabis investments since an investor can more accurately estimate the total addressable market in the future. In addition, when thinking about how large the market may become at maturity, we must factor in the additional demand from new form factors not readily available on the illicit market as well as new consumers who want cannabis but refuse to purchase it illegally. In other words, since illicit market demand estimates consider only the amount of flower demand from consumers who are willing to purchase marijuana illegally, we believe the transition of illegal demand to legal demand is greater than a 1:1 ratio.
- 2. The cannabis industry is constrained for capital, which has created a material funding gap.** Private U.S. cannabis companies have annual capital needs of \$35 billion to \$53 billion but are receiving only approximately \$4 billion in funding (approximately 15-30% of their capital needs) today. This material funding gap creates an opportunity for early investors, as it allows access to deals that may not be available in an industry with access to enough capital.

## FUNDING GAP CREATES OPPORTUNITY

We estimate only 15-30% of private cannabis companies are being funded



### Funding Gap Drivers

- (i) Vice Clauses
- (ii) Regulatory Limitations
- (iii) Broader Economic Downturn

For comparison, a similar emerging industry such as artificial intelligence (AI) has far more institutional dollars chasing deals, driving up valuations and limiting access to the best opportunities. According to the 2022 [Stanford AI Index report](#), private venture investment in AI exploded to \$93.5 billion in 2021, more than doubling the 2020 tally.

- **Cannabis companies, especially plant-touching businesses, face policy barriers in the U.S. banking system.** According to the U.S. Treasury Department, the agency has identified 553 banks (about 11 percent of all U.S. banks) and 202 credit unions (about 4 percent of all U.S. credit unions) that are “actively providing banking services to marijuana-related businesses.” A [February 2022 survey](#) by Whitney Economics found that more than 70 percent of respondents said the “lack of access to banking or investment capital” was their top challenge.

If banks do work with cannabis businesses, they often charge large monthly account and transaction fees to offset the perceived risk and extra costs incurred to comply with federal government regulations. There are no laws prohibiting banks from doing business with cannabis companies, however banks are required to file reports with the federal government detailing any illegal activities they believe are going on with their account holders. These are time-consuming and costly reports that if filed incorrectly can expose the bank to the possibility of large fines. This risk is often enough for banks to institute a no-cannabis policy today. As a result, the annualized cost of capital for a U.S.-based cannabis company has been as high as 30-40% (after factoring in the value of warrants or unregistered shares), according to Forbes. This unreasonably high cost of capital has forced cannabis companies to access the equity market instead, which traditionally is considered a last resort, given raising equity capital is dilutive to existing ownership.

- **Vice clauses will prevent some in-flow of capital even after prohibition has been lifted.** Many venture capital and private equity funds operate under what are known as vice clauses. These restrictions imposed by limited partners, usually large institutions, such as public pension funds and ME sovereign wealth funds, prevent them from investing in certain sectors, such as alcohol, tobacco, firearms, pornography and cannabis (“sin-related” industries). Even after the lifting of federal prohibition, many funds with vice clauses will still stay away from cannabis, lessening the amount of total capital pursuing cannabis opportunities. Even in cases where limited partners do not insist on vice clauses, many of the largest private equity and venture capital firms do not invest in sin-related industries to protect their own reputation.
- 3. Many early-stage cannabis companies have similar business models to mature companies in non-cannabis industries, increasing the visibility into strengths and weaknesses.** This generally reduces the risk of a potential investment since the company in the mature industry can be used as a comparable when evaluating the strengths, weaknesses and financial performance of the target cannabis company prior to making an investment. The table below shows illustrative examples of non-cannabis businesses and their comparable counterparts in the cannabis industry.

SECTOR	TRADITIONAL INDUSTRY OPERATOR	CANNABIS INDUSTRY OPERATOR
Data Analytics	<ul style="list-style-type: none"> <li>Market research company providing CPG clients with consumer, shopper and retail market intelligence</li> <li>Exit: Acquired by PE firm Vestar for 16x+ EBITDA<sup>1</sup></li> </ul> 	 <ul style="list-style-type: none"> <li>Market research company providing clients with cannabis &amp; CBD consumer, shopper and retail market intelligence</li> <li>Anticipated exit*: Strategic acquirer (e.g. IRi)</li> </ul>
Distribution Services	<ul style="list-style-type: none"> <li>Largest wine and spirits distributor in the United States with 22,000+ employees and \$21b revenue (2022E)</li> <li>Exit: Privately owned, controls ~35% of the \$61bn market</li> </ul> 	 <ul style="list-style-type: none"> <li>Largest supply chain solutions company and California-based distributor of cannabis products</li> <li>Anticipated exit*: IPO or Strategic acquirer (e.g. SGWS)</li> </ul>
Media	<ul style="list-style-type: none"> <li>Online marketing services. Specializing in online marketing, telephone sales and building technology infrastructure</li> <li>Exit: PE Backed by Silver Lake for \$1bn post-money</li> </ul> 	 <ul style="list-style-type: none"> <li>Performance marketing and collection of digital properties</li> <li>Anticipated exit*: Strategic acquirer (e.g. Media firm)</li> </ul>
Marketing Tech	<ul style="list-style-type: none"> <li>Customer engagement platform providing communication tools (SMS, email, voice) for businesses</li> <li>Exit: IPO'd in 2016, \$37.6bn market cap as of Feb 2022</li> </ul> 	 <ul style="list-style-type: none"> <li>Marketing &amp; messaging platform providing brands and retailers loyalty &amp; digital communication solutions</li> <li>Anticipated exit*: IPO or Strategic acquirer (e.g. Klaviyo)</li> </ul>
CPG	<ul style="list-style-type: none"> <li>Multinational drink and brewing company with 17,500+ employees and ~\$10bn revenue (TTM)</li> <li>Exit: IPO'd in 1975, \$10.5bn market cap as of Feb 2022</li> </ul> 	 <ul style="list-style-type: none"> <li>Vertically integrated multi-state operator providing cannabis products to the CO, IL and MI markets</li> <li>Anticipated exit*: IPO or Strategic acquirer (e.g. Constellation)</li> </ul>

- 4. Mature U.S. companies are reluctant to expand their business into the cannabis space, reducing competition for early-stage cannabis companies.** Although mature U.S. companies may be interested in cannabis and may be actively researching cannabis, generally they would rather wait for federal legalization prior to expanding into the space due to the over-loomng risk that the federal government may never lift prohibition. This presents an opportunity for cannabis entrepreneurs and investors alike, as it allows them to build businesses without facing direct competition from large U.S. corporations. Early-stage companies in emerging, federally legal industries, such as blockchain technology or AI, will be forced to fight the uphill battle that is the direct competition of large U.S. corporations that are better capitalized and have access to far greater resources. For example, many AI start-ups will have to compete with Google AI, Google's research and development branch for AI applications. Similarly, many blockchain start-ups will go head-to-head with top developers at IBM. In an article ranking market leaders in blockchain technology development, Forbes ranked IBM first, stating "IBM's blockchain solutions efforts are supported by some 1,500 experts, with the company participating in more than 500 blockchain projects."
- 5. Mature companies that are currently reluctant to expand into cannabis will likely acquire cannabis companies operating in a similar sector within cannabis as the regulatory environment continues to ease.** Since cannabis companies often have similar business models to mature companies in non-cannabis industries, we find it easier to identify future exit scenarios when underwriting an investment in a cannabis company as compared to their non-cannabis industry peers. We believe partnerships formed between mature non-cannabis companies and early-stage cannabis companies are often a precursor to a later acquisition. Forming a partnership today allows a non-cannabis company to start building relationships with a cannabis company in a similar sector. A clear example of this can be found when looking at two recently formed partnerships in the data analytics space:

- In June 2021, a subsidiary of Toronto-based LP Cronos Group purchased an option to acquire approximately 10.5% of PharmaCann, one of the largest privately held cannabis companies in the United States, for \$110.4 million. Cronos is backed by the tobacco company Altria, which we believe is a strong indicator of the strategic tobacco players looking to get more involved in both the U.S. and Canadian cannabis markets.
- More recently in September 2022, North Carolina-based Open Book Extracts announced a strategic investment from Btomorrow Ventures, the corporate venturing unit of British American Tobacco (BAT). In addition to the funding, OBX and BAT also signed a scientific collaboration agreement covering certain areas of future R&D. Under the collaboration, the two companies will focus on next-generation cannabinoid ingredients and may in the future include a review of the potential effects and benefits along with formulation science across product formats.

## **Section 5: Broad Acceptance, Reduced Stigma Shift Attitudes and Open Investment Opportunities**

As noted earlier, there is now widespread support among the American public for legalization of cannabis at the federal level. This support crosses political boundaries as well as geography, with conservative, centrist and liberal areas of the nation all demonstrating support for legalization. According to an April 2022 survey conducted by market research firm SSRS, a full 69% of Americans back adult-use legalization, and 92% back medicinal use of cannabis. The depth of support becomes even more apparent when you break down the numbers: The SSRS survey revealed that 78% of Democrats, 74% of independent voters and 54% of Republicans said they favor adult-use legalization. The same survey also found that 58% of Americans now agree that marijuana is less harmful than alcohol.

Furthermore, a separate survey from cannabis company Jushi Holdings released in April 2022 found that support for political candidates favoring cannabis legalization is also increasing. According to the survey, 61% of adults aged 21 and older reported they would be more likely to vote for a candidate that supports legalization. This same poll found the following:

- 76% of Americans favor allowing military veterans to access medical cannabis
- 68% believe the federal government should allow cannabis businesses to access the financial system
- 62% feel that legalization plays an important economic role in the United States
- 57% believe that the cannabis industry creates high-quality jobs

Perhaps most revealing, 59 percent of respondents agreed that “cannabis overall has a positive impact on society.” Clearly, these numbers represent a sea change in attitude toward cannabis in the United States, and point to a dramatic decrease in stigma surrounding cannabis among nearly all segments of society. Investors who previously pointed to cannabis stigma as a reason for avoiding the industry have good reason to believe this stigma is no longer a strong factor.

## Recognition of the inequities of the War on Drugs deepens cannabis acceptance.

In order to understand the current public and policymaker attitudes toward cannabis, it is important to know why cannabis was outlawed in the first place. Until the early 20th century, there was no such thing as an illegal drug in the United States. Cannabis was in the *United States Pharmacopeia* from 1854 to 1941. It was one of the three ingredients most used in patent and prescription drugs, and it was produced by many leading pharmaceutical companies, including Squibb, Merck, Parke-Davis and Eli Lilly. However, a series of policy and legislative decisions beginning in 1914 effectively sealed the fate of cannabis for nearly the remainder of the century. While there has always been the claim that policies enacted during this time period were systemically racist in nature, it has not been until very recently that these arguments have become conventional wisdom. An overview of actions taken during those years underscores the resulting racial inequities:

- In 1914 the Harrison Narcotics Tax Act became the first federal law criminalizing the nonmedical use of drugs. The act outlawed the sale of cocaine and opiates but did not include anything about cannabis usage. However, the government's laissez faire approach to cannabis would change over the coming years.
- From 1910 to 1920, Mexico underwent a series of conflicts known collectively as the Mexican Revolution, which drove tens of thousands of Mexicans north into the United States. The influx of laborers created a backlash from white farmers and ranchers who could not compete with larger ranchers who economically benefited from the cheaper Mexican labor. As a result, several Southwestern states passed economically and racially motivated anti-marijuana laws since marijuana was widely used among Mexican workers. This was also the first time that anti-drug proponents swapped the commonly used term cannabis for *marijuana* or *marihuana*.
- In 1930 Harry Anslinger was appointed as the first director of the U.S. Treasury Department's Federal Bureau of Narcotics (no Drug Enforcement Agency existed) that was tasked with enforcing the prohibition of alcohol and illicit drugs. Well known to hold racist viewpoints, Anslinger launched a national campaign to assail the so-called evils of marijuana that culminated in 1937 with the passage of the Marijuana Tax Act. The act imposed such heavy restrictions that it effectively outlawed cannabis and was passed despite the American Medical Association's (AMA) testimony to the House Ways and Means Committee rejecting the notion that cannabis was a harmful substance.
- This effective ban on cannabis was codified into law in 1970 via the Controlled Substances Act (CSA) and was followed by President Richard Nixon's infamous declaration of the "War on Drugs" in 1971. The CSA divided drugs into five schedules, from least medically useful and most susceptible to abuse, to more medically valuable with less abuse potential. Cannabis was placed in the most restrictive category, Schedule I, where it remains to this day. Despite Nixon's own drug commission's 1972 report recommending the legalization of recreational cannabis, the President refused to change the Schedule I status of cannabis. In a 2016 interview with Harper's Magazine, Presidential aide John Ehrlichman provided context as to why the administration went against the commission's recommendation:

*“The Nixon campaign in 1968, and the Nixon White House after that, had two enemies: the antiwar left and black people ... We knew we couldn’t make it illegal to be either against the war or black, but by getting the public to associate the hippies with marijuana and blacks with heroin, and then criminalizing both heavily, we could disrupt those communities ... We could arrest their leaders, raid their homes, break up their meetings and vilify them night after night on the evening news. Did we know we were lying about drugs? Of course we did.”*

Today, the fact that much of the War on Drugs was precipitated on racist policies has been widely accepted, radically altering attitudes toward cannabis in the process. Most cannabis businesses, whether they work directly with cannabis (plant-touching businesses) or work to support the industry (ancillary companies) now advocate for social equity programs to increase opportunities in the industry for minority populations. Legislation in states considering legalization now routinely includes social equity components. For example, both Illinois and New York included strong social and economic equity provisions in their legislation that aims to equal the playing field in the awarding of licenses while righting the wrongs of the unfair incarceration of minorities during prohibition.

The shift in attitudes toward cannabis, broad support for legalization and wide acceptance that the War on Drugs was seriously flawed are combining to dramatically reduce stigma, as well as boost investor confidence. Many investors we’ve spoken with have had some level of experience with the private cannabis industry but have struggled to get comfortable with how to approach the sector. Since there is such a wide spectrum of early-stage cannabis businesses raising capital in an industry that is so rapidly changing, we have found that even the most sophisticated investors struggle to develop an investment thesis. The question is: How does an investor manage risk in an industry that is constantly evolving?

Where we once believed that a focus on ancillary investments was a more prudent approach, KEY now advocates for a balanced approach between ancillary and plant-touching investments. We are confident both the ancillary and plant-touching sectors will experience rapid growth over the next five to 10 years, and believe that investing in both spaces now will achieve superior risk-adjusted returns when compared to the ancillary space alone.

- Ancillary cannabis investments have the opportunity to dominate this niche while still appealing to other industries
- Plant-touching opportunities represent a higher potential for immediate return
- Investing in both promotes a long term and short term opportunity

## Section 6: Conclusion

Given the current status of the U.S. political landscape and the large funding gap in the cannabis capital markets today, we believe that the cannabis market is at an inflection point. Many investors understand the window of opportunity in front of them and are anxious to put capital to work, however it is important that when evaluating investments, these investors don't make the mistake of relying more on the projected growth on the industry than they rely on thorough due diligence and analysis. In an emerging, federally illegal industry with a constantly changing regulatory environment, the need for thorough due diligence and analysis is greater than ever.

Due to the massive growth expected to occur in the cannabis industry over the next five to ten years, it is reasonable to assume that cannabis investments collectively will outperform many other mature asset classes such as real estate, private equity, public equities, or fixed income. The question is, which early-stage companies today will be responsible for driving this outperformance?

Based on our analysis of the U.S. cannabis market and the wide array of investment opportunities we have seen to date, we conclude that companies which exhibit the following characteristics generally will provide the best risk-adjusted returns in the cannabis industry.

The company should:

- Be led by an exceptional management team with a proven track record of success (generally outside the cannabis industry);
- Show potential for high growth and the ability to scale;
- Be able to sustain their competitive differentiation over time;
- Generally, not be taking too much speculative risk by investing heavily in R&D;
- Be expected to benefit from the lift of federal prohibition (i.e., the business should not be solving a problem that no longer exists after the lift of federal prohibition); and
- Have relatively good visibility into an exit via the identification of a likely strategic acquirer that exists in the non-cannabis space and/or strong likelihood for an IPO on a major exchange.

Cannabis prohibition only lifts once!

## Contact Information

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### **About KEY Investment Partners LLC:**

KEY Investment Partners is an investment management firm focused on providing growth capital to early-stage cannabis companies. The firm invests opportunistically across all sub-sectors of the cannabis industry, with the intent of identifying high-growth, market-leading companies that are backed by exceptional management teams. Pete Karabas, Tiby Erdely and Jordan Youkilis co-founded KEY after the three worked together at the Swiss-based private equity firm Partner's Group AG (SIX: PGHN) for several years.

The team has over 38 years of combined investment management experience at institutions such as Partners Group, Goldman Sachs, GE Antares Capital and Equity Residential, where they invested on behalf of some of the largest pension funds and endowments in the world. KEY is headquartered in Denver, CO - the most established and mature legal cannabis market in the US - positioning the firm at the forefront of the most exciting trends and developments in the space.

To learn more about KEY Investment Partners LLC, please visit [www.keyinvestmentpartners.com](http://www.keyinvestmentpartners.com) or reach out via email at [contact@keyinvestmentpartners.com](mailto:contact@keyinvestmentpartners.com).

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