ONE MORE DANCE WITH MARY JANE

NEW POT LAWS MAKE MARKETS GROW LIKE 'WEEDS' — FOR A WHILE

BY STEVE LEWIS

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When states like Colorado first began legalizing the medical, and even recreational, use of marijuana, many predicted a huge bonus in sales tax revenue for the state. It is not clear, however, how many accurately predicted a boom in industrial real estate, where formerly obscure and unattractive B and C warehouses were turned into gold.

An article in *National Real Estate Investor* entitled "What's Next for Marijuana Warehouses?" said that, according to CBRE, in 2016, industrial properties occupied by marijuana businesses in the Denver market sold for $115 per square foot, "a 25 percent premium over traditional Class-B and Class-C industrial spaces."

The article went on to note that CBRE cited an average effective rental rate for marijuana-growing sites in the Denver area at $14.19 per square feet on a triple net basis, based on a review of 25 leases signed between 2014 and 2016 – or two to three times higher "than the average warehouse rental rate in the area's top four cultivation sub-markets." CBRE also said that 3 percent of the region's total warehouse market, or 4.2 million square feet of industrial space, was occupied by marijuana growers in the fourth quarter of 2016."

And Colorado is not alone. Kalyx Development, a private real estate investment trust focused on the pot business, owns nine buildings in four states, and, according to a *New York Times* article, "A Real Estate Boom, Powered by Pot," it plans to expand into three or four more states this year, driven largely by demand from investors who want to put money to work.

The same article quotes Chuck Allen, a commercial broker with Keller Williams Realty who works in Monterey, Calif., as saying that in the last few years, more than 20 major transactions worth roughly $100 million have closed, and prices are on the rise. "Last year, you'd have paid about $2.5 million for a 10-acre parcel with greenhouses," he said. "Today, you'd pay $5 million."

Paul B. Kluck, SIOR, first vice president, CBRE | Advisory & Transaction Services, Industrial & Logistics in Greenwood Village, Colo., is keenly aware of the impact new marijuana laws have had on industrial real estate. (The new Colorado legislation was voted into law in November 2012, and made effective 1/1/2014.)

"In November 2012 the market was down, with vacancies much higher than they currently are, and in a down market B and C properties suffer the most," he notes. In 2013, he continues, "There was a whole speed-to-market; it takes two to three months to grow and prepare marijuana so everyone was scrambling to get in place by 2014. They gobbled up a fair amount of that 4 million square feet, which jump-started the recovery here in Denver."

Kluck, however, is not sure the future looks quite as rosy. "Because of efficiencies in growing, the price of a pound has dropped almost two-thirds," he notes. "We've had some consolidation; there have been some efficiencies in growing techniques, and the less than efficient growers are being weeded out."

At this point, he continues, since Denver is in the consolidation phase, "Everyone who wants to be in on the business is in on it. The market's a little overgrown, and we're not seeing any new players."

Kluck says, "There is still a fair amount of demand, but what happens when we see more and more states legalize recreational marijuana?"

He sees a reduction in demand as pot becomes more available in other states – and that's not all. "Most operators I speak to today, if they started in 2013-14 they now have to upgrade facilities, add new technology, and re-invest," Kluck points out. "Plus, the taxes are huge; because they are federally illegal, none of their operating expenses are deductible. You have to pay federal income tax on gross profit."

COMING ATTRACTIONS?

Of course, the experiences seen in Colorado, California, Oregon, etc., may be repeated in other states as they enact their own laws – and many of them appear to be jumping on the bandwagon. According to CCIM, there are currently 31 states that permit medical marijuana. Alaska, Colorado, Maine, Massachusetts, Nevada, Oregon and Washington currently permit recreational use of the drug.

So how are SIORs in other areas preparing for the future? "The biggest challenge is locating the properties that can operate due to ownership, state/county laws and location restrictions," says Allan Riorda, SIOR, president and principal of Lee & Associates, Columbia, Md. "Those that typically arise are in zoning, neighborhood/political opposition, and location requirements from churches, schools, etc." However, he adds, he has done business in this area.

Medical marijuana was legalized in 2015, he notes. "Laws were tweaked and modified so that in late 2017 the first dispensaries were open (there are now 102) and growers are delivering product," Riorda adds.

Perhaps because of its proximity to Washington, D.C., the sites approved for any marijuana grower or dispensary are limited due to it still being illegal on the federal level, says Riorda. "This eliminates any publicly held companies from entering into a lease. Buildings that are financed can also be precluded from being leased as well."

As a result, he says, the dispensaries are located in smaller "strip centers" or freestanding locations – either in a lease or sale situation. "The sales we have seen have been all-cash," says Riorda. "The growers are well funded."

Growers have either leased or purchased facilities that are +/- 40,000 square feet and have invested substantial dollars on the infrastructure, he continues, adding that in multi-tenanted buildings, there has been "push back" from neighboring tenants.

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"From an industrial market standpoint, the growers can operate in a B or C class building as loading, lower ceiling heights and narrower column spacings are typically not a deterrent from an operational standpoint," Riorda observes. "The grower's building requirements are usually the amount of electrical service that is available."

As to Lee & Associates' approach to this market, Riorda says, "We strive to provide a high level of service to them as we do with all clients."

The status of marijuana laws in Florida is "somewhat in limbo," says Kenneth E. Morris, SIOR, CEO and president of Morris Southeast Group, based in Weston. "We have legislation that allows for a specific strain of non-euphoric medical marijuana called 'Charlotte's Web,'" he shares. "The state has restricted [the issuing of licenses] to five very, very large agricultural concerns with the ability to grow."

This is "really a shame," he continues, "because the demand pattern is here. A lot of local municipalities are open to having cannabis-related industries." While there really is no market yet, Morris is preparing for the possibility. "I've talked to several doctors getting their licenses ready to prescribe, but it's still very nascent," he says. "A perceived monopoly for only five or so is not good; a lot of people want to be in the business." He also notes, "At the federal level the current administration is not cannabis-friendly."

Still, Morris says he is "basically cataloging buildings in markets where I think it will work." He has also spoken to several zoning officials to determine if they are "up for it" or not. "I know what areas would and would not be good," says Morris. "Finding real estate, at least for the first wave, will not be hard; we're just not there yet."

Noting, as Kluck did, the drop in prices, he's also pretty clear on the types of businesses that will work, and which will not – the implication being that the "weed rushes" of Colorado and California may no longer be able to be replicated. "The price of flowers has dropped from $1,700-$1,800 a pound to $1,000-$1,100, which is affecting business," he observes. "The real money will not be made in growing but in processing for edibles and ointments. That's where the real money is going to be seen."

While he recognizes the potential risk of a more aggressive federal government, which could "send shock waves" through the industry, the potential market should

not be ignored. "The industry has its merits," he asserts. "I think it does a lot for the end user, as well as for archaic properties that would sit until they are demolished."

THE "NORTH COUNTRY": A DIFFERENT STORY

The situation in Canada is quite different, since it doesn't share the U.S. challenge of state laws differing from federal laws. According to the federal government's website, "The proposed Cannabis Act would create a strict legal framework for controlling the production, distribution, sale and possession of Canada .... with a target date of no later than July 2018."

"The stock of obsolete industrial buildings may be soaked up, but it is important to remember that in Canada, cannabis will be legal in the entire country at the same time, which is very different than the USA," notes Sandy G. Shindleman, SIOR, president of Shindico Realty, Inc., in Winnipeg.

"Denver, for example, saw an inflow of capital because it was one of the first states that saw legalization. Its industrial vacancy rate plummeted while rents sky-rocketed. I'm not certain if that will happen in specific Canadian markets."

From an industrial perspective, he continues, landlords appear more willing to lend their buildings to this type of use. "Marijuana companies can pay a higher rate than a manufacturer, and are often willing to move into properties that cannot be used as DCs or traditional industrial uses," he notes.

Shindico has worked with a group that was bidding on the retail licenses in Manitoba. "They were very professional and well financed," he says. "Their concept was advanced, and focused on being discrete while ensuring that the product and customers were always as safe as possible." His company's search for them revolved around rural locations and free-standing buildings where they wouldn't have to worry about co-tenancies.

In terms of working with such companies, Shindleman says his company focuses on "Determining what a cannabis producer needs. What do they look for in an industrial property? Are there certain characteristics that benefit them that may not benefit traditional users of industrial space?"

Speaking of Alberta, Chad Boddez, SIOR, senior vice president, Office Leasing & Sales, JLL, in Edmonton, has seen some significant changes.

"What has changed is that we are receiving constant calls from entrepreneurs and established groups looking to open retail outlets; lately, about one out of every five calls our retail group receives has to do with finding space for a dispensary," he shares.

Nobody is really jumping in headfirst yet, he adds. "Most major landlords will currently not entertain entering into any type of lease agreement, even conditionally, as cannabis is still illegal," he points out. "C-Class properties are seeing a surge of activity as most potential dispensaries can't secure A-Class sites and the

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landlords of the C-Class buildings are less concerned about their legal risk of completing a lease transaction prior to cannabis becoming fully legal."

Boddez shares that he recently represented the Alberta Gaming and Liquor Commission (AGLC), an agent of the Alberta government that will be responsible for regulating cannabis within the province. "On November 16, 2017, the Government of Alberta stated that cannabis would be sold online through a government website and through privately operated stores," he says. "AGLC was informed shortly after this date that they needed to move forward with securing their operations by July 1, 2018, to regulate the industry. They informed me they wanted to be up and running as soon as possible, and required approximately 40,000 square feet That is not an easy request in my market. We were fortunate and secured a sublease where the sub-landlord left all furnishings behind."

As for research related to such properties, Boddez says "An SIOR should first consult with the landlords they represent to ensure they are okay with a cannabis use for their property. Second, the zoning of the property should be checked to ensure the operation of the cannabis establishment meets civil bylaws. Many municipalities are still determining their zoning bylaws, and if they will be similar or separate from stores that sell liquor."

THE FUTURE IS UNCLEAR

There is a diversity of opinion among SIORs as to what the future holds for this sub-sub-market – perhaps because of the different stages of growth in which they find themselves. "We see it as being a benefit to industrial landlords," says Boddez. "Ultimately there is new demand for old and new industrial product. That should put pressure on vacancy and rates, especially in markets like Winnipeg that have experienced the rate growth that more urban centers have."

Riorda notes that as the industry is growing nationally, a broker could align himself with the major players within the industry to service multiple markets with a local partner.

In Denver, however, the good times may have faded. When the boom began, Kluck recalls, "I called every owner in town saying, 'Hey, want to sell?' and probably sold half a dozen properties. But by the end of 2014 the bud was off the rose."

The *New York Times* author David Gelles was also far from sanguine when it came to future prospects. " … As the industry matures, many executives believe that tenants and investors spending big money on such projects could soon find themselves underwater," he wrote. "Ultimately, the theory goes, growers are likely to turn to less expensive greenhouses. And if federal regulations about the transportation of marijuana loosen, dispensaries in Boston could soon sell buds grown in California greenhouses."

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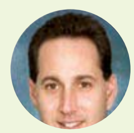

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