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Deep Dive: Medicine Man Technologies sets stage for long-term profitability

Medicine Man Technologies (**OTC: MDCL**) provides a case study for building an intelligent, long-term cannabis strategy. By vertically integrating profitable operators in Colorado through several recently announced acquisitions and using capital and corporate integration experience from a large partner/investor to expand sales and margins, they are building sustainability.

In short, MDCL is the exact opposite of many other cannabis companies beset by red flags for investors: management turnover, huge cash-flow losses, unfunded business plans, overly ambitious strategies and complex capital structures.

Many cannabis companies promised the world, raised a lot of capital and promptly burned most of it assuming they could raise more. Now, faced with tight capital markets, many are scaling back operations.

We at *Investor Intelligence* believe the best investment opportunities have similar elements:

1. Quality fiduciaries: high-quality management teams aligned with shareholder interests.
2. Sustainable and profitable business model.
3. Sound strategy.
4. Adequate capital to fully execute the strategy.

The best investments have identifiable catalysts investors can use to judge management's progress versus the stated business plan, with the ultimate goal of creating shareholder value over time.

Medicine Man has the high-quality fiduciaries, the profitable business model, the sound strategy and identifiable catalysts. The company has a lot of cash on the balance sheet, but it still needs to raise more cash to close the acquisitions.

We expect MDCL will be able to issue debt thanks to its significant EBITDA.

The structures of their recent acquisitions align the incentives of the new MDCL management team and its shareholders. Once the acquired firms in Colorado are integrated, we believe management can repeat this growth strategy in multiple other states.

PREVIOUS COLORADO REGULATIONS FORCED PROFITABILITY

When Colorado legalized recreational marijuana in 2012, **regulations capped the number of out-of-state owners at 15**, effectively limiting out-of-state capital from investing in Colorado companies. With access to capital hindered, operators were forced to run profitable businesses to generate enough cash to self-fund their growth.

On **May 29, 2019, Gov. Jared Polis signed HB19-1090**, removing that limit and opening licenses to public companies, effective Nov. 1, 2019.

Andy Williams, the founder, CEO and major equity holder of Medicine Man Technologies, was a strong proponent of the new law.

PIONEERS IN 2009; CONSOLIDATORS IN 2019

Williams founded Medicine Man in 2009 with his brother Peter.

In 2016, the non-plant-touching consulting and nutrient business went public as Medicine Man Technologies, while the other two division continued to operate privately. MDCL provides consulting services to multiple cannabis companies, so it has firsthand knowledge about which firms are efficient, well-run operations—and which are not.

With the legal ability and capital to consolidate the industry, MDCL has implemented a strategy to acquire the best operators in Colorado. In January 2019, MDCL announced it would acquire Medicine Man Denver, a cultivator with four dispensaries, and MedPharm, an extractor and researcher. The company then pursued a string of 12 acquisitions of the top operators in Colorado between June and August 2019.

The acquisitions are described in the **company's investor presentation** and also are listed in our tables below. Medicine Man Technologies has now joined forces with other experienced long-time operators to build a vertically integrated company focused on Colorado cultivation, extraction, processing, brands, medical research and retail distribution.

The reporters at *Marijuana Business Daily*, who have followed the market since its inception, corroborate the quality and longevity of these operators. See their **stories about the businesses**.

Medicine Man Technologies' one acquisition outside Colorado—and frankly not core to the investment thesis—is Green Acres SAS, a cultivator in Colombia that we view as a long-term option on the development of a global export market and a hedge on higher-cost domestic production should the United States ever allow imports of cannabis.

Medicine Man Technologies' success is not simply a matter of vertical integration; others have tried with **mixed results**. It MDCL's selection, insistence of profitability and alignment that stands out.

ACQUISITION STRUCTURE ALIGNS MANAGEMENT INCENTIVES

Medicine Man Technologies has used contingent consideration (equity and cash earnouts), with lockups to align the incentives of the acquired management teams and paid very reasonable multiples of EBITDA for the acquisitions (even compared to non-cannabis businesses). We view this as a positive both for shareholders and company execution going forward because incentives are aligned to drive performance for the entire MDCL organization, not just the sellers' specific operations.

A major risk in acquiring a founder-led firm is that after the deal closes, the founder loses focus or interest and, subsequently, performance of the acquired company deteriorates. Issuing shares in lieu of cash for acquisitions is dilutive to the acquiring firm's shareholders, but it works well to align incentives of the acquired management team with the purchasing firm's shareholders and the managers of the other acquisitions.

As shown in the table below, the final price the acquired firms receive is based heavily on future performance of their firms and MDCL overall. The average cash at close paid for the acquisitions is only 42% of the total consideration. No acquisition is pure cash, and the maximum cash at close is 50%.

The equity component is, on average, 45% of total consideration. The deals range from 25% to 92% of equity and are subject to one-year lockups. The acquisitions with lower equity percentages have cash earnouts to be paid in 2021 if the acquired firms attain certain performance metrics in 2020.

Even in acquisitions with cash earnouts, the use of MDCL stock aligns the acquired firm's management team for the benefit of the entire company and public shareholders.

Further protecting shareholders is that most agreements are subject to renegotiation if the actual performance is +/- 10% compared to undisclosed targets in the letters of intent.

The upside for shareholders of the acquiring firm is that while they own less of the combined firms, the greater size of combined entity more than offsets the dilution.

In the table below, the June-September acquisitions include actual figures found in the 8K filings. The line combining the acquisitions of Medicine Man Denver and MedPharm, announced in January 2019, estimates an acquisition price of $54.2 million and the cash and equity breakdown. The only disclosures for Medicine Man Denver and MedPharm would add $40 million-$50 million of revenue (table uses the midpoint of $45 million) and that there is an equity component at the MDCL price in January 2019 of $1.32.

MDCL's September 2019 investor presentation states total consideration for the acquisitions of $286 million. The June-September acquisitions total $232 million, implying $54 million for the January acquisitions. The June-September acquisitions have an average equity percentage of 45%; we applied this same percentage to estimate the equity portion for the January acquisition and used a share price of $1.32 to estimate the number shares.

MDCL ACQUISITION COMPOSITION

Date	Pending Acquisitions	Total Consideration	Cash Consideration at Close	1+ Yr Cash Earnout	Equity Consideration	Equity % of Total	Contingent %	Shares (millions)	Deal Price
6/5/19	Los Sueños (Los Sueños, Farmboy, Baseball)	$11.87	$2.38	$-	$9.50	80%	80%	3.2	$3.01
6/5/19	Mesapur dba Purplebee's	$12.01	$2.40	$-	$9.61	80%	80%	2.8	$3.43
6/12/19	Green Equity SAS (Columbian Farm)	$5.40	$0.45	$-	$4.95	92%	92%	1.3	$3.83
8/15/19	Cold Baked & Golden Works dba Dabble Extracts	$3.75	$0.75	$-	$3.00	80%	80%	1.0	$3.01
8/15/19	Unidentified edible company (implied to be Medically Correct)	$17.25	$3.45	$-	$13.80	80%	80%	4.7	$2.95
9/3/19	Starbuds	$31.01	$15.50	$7.75	$7.75	25%	50%	2.6	$2.98
9/4/19	Colorado Harvest	$12.50	$4.00	$-	$8.50	68%	68%	2.9	$2.95
9/5/19	Dispensaries dba Starbuds	$36.90	$18.45	$9.22	$9.22	25%	50%	3.1	$2.98
9/6/19	RootsRx	$15.00	$7.50	$2.25	$5.25	35%	50%	1.8	$2.95
9/9/19	Dispensaries at 35% margin dba Starbuds	$49.97	$25.05	$12.52	$12.40	25%	50%	4.2	$2.95
9/11/19	Strawberry Fields	$31.00	$14.00	$-	$17.00	55%	55%	5.7	$2.98
9/12/19	Canyon & It Brand	$5.13	$2.57	$-	$2.57	50%	50%	0.8	$3.07
TOTAL JUNE-SEPTEMBER 2019 ACQUISITIONS		**$231.79**	**$96.49**	**$31.75**	**$103.55**	**45%**	**58%**	**34.0**	**$3.04**
1/15/19	Estimated Medecine Man Denver & MedPharm	$54.21	$29.81	$-	$24.39	45%	45%	18.5	$1.32
TOTAL PENDING ACQUISITIONS		**$286.00**	**$126.31**	**$31.75**	**$127.94**	**45%**	**56%**	**52.5**	**$2.44**
TTM Rev June 2019 Core MDCL								41.3	
TOTAL PRO FORMA MDCL BEFORE WARRANTS			**$129.59**					**93.8**	

VALUATIONS REASONABLE ON HIGHLY PROFITABLE BUSINESSES

The new MDCL has a profitable **pro forma business model with $170 million in revenue at a 20% margin**, for EBITDA of $34 million. We confirmed with the company that this $170 million and 20% margin includes the current MDCL businesses and adjustments for future intercompany transfers from vertical integration (e.g., Los Sueños product counted as COGS when sold in Starbuds), so there will not be a reported revenue headwind versus the $170 million base as the companies vertically integrate.

All the acquired businesses are already well run and individually profitable, with some having disclosed surprisingly high 30%-35% EBITDA margins, and the overall EBITDA margin for the pro forma business is 20%. These margins are high for any consumer, agricultural or industrial business.

The acquisition multiples were quite reasonable for any business at 1.83X revenue and 7.4X EBITDA. The table below cites acquisition-specific multiples when they were disclosed, usually as "minimum margin targets."

The fear for an acquirer buying high margins at normal to lowish multiples is that the acquired business is cyclically over-earning and about to see margin compression. We do not believe that is the case with MDCL, because the catalyst for these sales is the change in Colorado law that enables consolidation. The fact that the sellers are also taking so much equity with lockups means they are not truly cashing out at the top.

The table below outlines the revenue, EBITDA, margins and acquisition multiples paid, based on publicly available information. We have used the trailing 12 months actual revenue and EBITDA for the core MDCL, though we believe MDCL is increasing its corporate overhead in anticipation of managing the acquisitions.

MDCL ACQUISITION PROFITABILITY AND VALUATION

Date	Pending Acquisitions:	Total Consideration	Sales	EBITDA	EBITDA Margin	EV/S Multiple	EV/EBITDA Multiple
6/5/19	Los Sueños (Los Sueños, Farmboy, Baseball)	$11.87					
6/5/19	Mesapur dba Purplebee's	$12.01					
6/12/19	Green Equity SAS (Columbian Farm)	$5.40					
8/15/19	Cold Baked & Golden Works dba Dabble Extracts	$3.75					
8/15/19	Unidentified edible company (implied to be Medically Correct)	$17.25	$13.80	$2.07	15.0%	1.25X	8.3X
9/3/19	Starbuds	$31.01	$19.00	$5.60	29.5%	1.63X	5.5X
9/4/19	Colorado Harvest	$12.50	$10.00			1.25X	
9/5/19	Dispensaries dba Starbuds	$36.90					
9/6/19	RootsRx	$15.00	$12.00	$2.10	17.5%	1.25X	7.1X
9/9/19	Dispensaries at 35% margin dba Starbuds	$49.97			35.0%		
9/11/19	Strawberry Fields	$31.00			18.5%		
9/12/19	Canyon & It Brand	$5.13	$3.30			1.55X	
TOTAL JUNE-SEPTEMBER 2019 ACQUISITIONS		**$231.79**	**$111.04**			**2.09X**	
1/15/19	Estimated Medecine Man Denver & MedPharm	$54.21	$45.00			1.20X	
TOTAL PENDING ACQUISITIONS		**$286.00**	**$156.04**	**$38.90**	**24.9%**	**1.83X**	**7.4X**
TTM Rev June 2019 Core MDCL			$13.96	$(4.90)	-35.1%		
TOTAL PRO FORMA MDCL			**$170.00**	**$34.00**	**20.0%**		

GROCERY CONSOLIDATION EXPERIENCE ALIGNED WITH 11%-19% OWNERSHIP

Dye Capital is a value-added investor for MDCL. Dye Capital brings expertise from its experience with Albertsons, which consolidated the grocery sector, and other large organizations such as United Airlines, Citibank and McKinsey. **(Meet the team at Dye Capital here)**. Justin Dye, Leo Riera and Nirup Krishnamurthy have all joined the board of MDCL. In addition, they've brought on leaders of the acquisition team at Albertsons: Lee Dayton now serves as MDCL's chief administration officer and Todd Williams (no relation to Andy) as chief strategy officer.

The investment firm has supplied $21 million to MDCL and now owns 10.5 million shares and 8.7 million warrants with a strike price of $3.50. With those shares, Dye Capital possesses 11% ownership of the pro forma company, and that stake climbs to 19% if the warrants are exercised for another $32 million.

We view Dye Capital as a long-term shareholder that will help MDCL integrate the acquisitions and raise the additional capital needed.

GOOD BUSINESS MODEL? 20% EBITDA MARGINS EXPANDING TO 30% SAYS YES

The 20% EBITDA margins of the pro forma Medicine Man and the 22% EBITDA margin achieved by the core Medicine Man Technologies business in 2018 are a testament to the effectiveness of the business model and execution of these operators. The company noted that all the acquisitions are individually profitable, and some margins ranging from 15%-35% have been disclosed in the 8K filings detailing those transactions.

MDCL's guidance notes that the 20% EBITDA margin can expand to 30% "via collaborative growth and the forthcoming economies of scale"—in other words, growing revenue via cross-selling and leveraging fixed overhead costs. A 50% incremental margin would need 50% revenue growth to get to a 30% margin, while using an 80% incremental would require only 20% revenue growth to get to a 30% EBITDA margin.

PRO FORMA SHARE COUNT IS 104 MILLION

Adding the shares issued in the acquisitions above and the warrants, we estimate the shares to be 104 million—assuming the warrants at $3.50 are exercised and the cash required is funded with debt.

	Shares (millions)
August 14, 2019 Shares Outstanding	**35.8**
August 15 Dye Capital Investment	5.5
Total Current Shares Before Warrants	**41.3**
Shares Issued in June-Sept Acq. - Actual	34.0
Shares for Jan. Acq. - Estimate	18.5
Pro Forma Shares before Warrants	**93.8**
Pre 2019 Warrants $1.33 avg Strike	1.2
Dye Capital Warrants $3.50 Strike	8.7
Officers' Grants Warrants $8.00 Strike	2.5
Pro Forma Share Count $1.33-$3.50	**95.0**
Pro Forma Share Count $3.51-7.99	**103.7**
Pro Forma Share Count above $8.00	**106.2**

MDCL STILL NEEDS $68 MILLION-$130 MILLION TO COMPLETE THE ACQUISITIONS

Despite the solid investment of capital and talent from Dye Capital, MDCL still needs to raise between $68 million and $130 million, by our estimates, in the next eight months or so, depending on the assumptions to execute these deals, as outlined below.

The 8-K filings for the June-September acquisitions have cash considerations at close that total $96.5 million. We estimate that the January acquisitions will require another $30 million in cash, assuming a similar mix of cash to equity (which, we admit, is a big assumption).

With the investments from Dye Capital through August and based on the cash balance at June 30, we assume the current cash balance is $28 million, though this is before any warrant exercises or operational cash flow (or burn).

The 8.7 million warrants owned by Dye Capital have a strike price of $3.50 and would generate $32 million of cash if exercised. With the stock at $3.37, this is possible but not guaranteed.

The earnout cash consideration of $32 million would bepaid a year after the acquisitions close (so, in first half 2021, assuming closings in the first half of 2020), but presumably, underperformance by these acquisitions would reduce the payment. MDCL will have about a year of operating cash flow and EBITDA of $34 million annually to partially offset this as well.

We believe MDCL will pursue debt financing for most of the cash rather than pure equity because it is generating cash and because of the comfort with debt shown by the new fiduciaries from Albertsons. Pro forma MDCL should generate $34 million of EBITDA annually, so borrowing $68 million to $130 million yields a reasonable leverage ratio of 2.0-3.8X. In comparison, Albertsons has borrowed $18.9 billion of debt on $3.5 billion of EBITDA, for a rather high leverage ratio of 5.5X.

Financing the $66 million in cash needed to close in 2020 would add 19.6 million shares at the current price of $3.37 if the deal is done entirely through equity.

	(millions of US$)
Cash at 6/30/2019	$4.3
July 16 Equity sale at $2.00	$7.0
August 15 Equity Sale at $2.00	$14.0
VVG Damages	$2.8
Current Cash before Warrants	**$28.1**
Cash Needed to Close June-Sept. Acq. in 2020 - Actual	$96.5
Cash Needed to Close Jan. Acq. in 2020 - Estimate	$29.8
Cash Needed at 2020 Close Before Warrants	**$98.2**
Warrant Proceeds at $3.50	$32.0
Cash Needed at 2020 After Warrants	**$66.2**
Cash Needed Deferred Earnout in 2021	$31.8
Total Cash Needed by 2021 After Warrants	**$97.9**

RAISING CASH TO CLOSE IS THE BIGGEST RISK

This all makes sense on paper, but the capital markets for cannabis stocks have tightened because of fears of overcapacity. However, MDCL is a different story: Colorado is a more mature market that is generating cash, and these acquisitions likely will lead to margin expansion via cross-selling and cost containment rather than incremental capacity to the market. It seems to us that this business plan should be able to access reasonably priced financing, but that is the main outstanding question.

VALUATION REASONABLE AT 9X-13X EBITDA

At $3.37, MDCL is trading at 13.2X the pro forma $34 million of EBITDA (assuming the warrants exercise and the company issues debt). Should it expand to a 25%-30% margin on the current revenue base, the multiple drops to 8.8X-10.5X.

More likely is that revenue growth leads to margin expansion. If the company can get to a 30% margin on 20% revenue growth (which implies an 80% incremental margin), the multiple drops to only 7.3X EBITDA. These figures yield a net debt/EBITDA ratio of 2X-3X, which is levered but reasonable. The current 13.2X EBITDA multiple on this scenario would yield about $6.85 per share.

The bear case is margin compression and revenue declines. If revenue declines 10% and margins decline to 15%, the multiple jump would jump to 19.5X and the leverage ratio to 4.3X. Clearly, the stock would decline in such a scenario; the current 13.2X EBITDA multiple on this scenario would yield a $2.00 stock price.

MDCL PRO FORMA VALUATION SCENARIOS

	Pro Forma	25% Margin	30% Margin	25% Margin, +10% Rev.	30% Margin, +20% Rev.	15% Margin, -10% Rev.
Revenue	$170	$170	$170	$187	$204	$153
% Change vs $170 million Pro Forma	0%	0%	0%	10%	20%	-10%
EBITDA Margin	20%	25%	30%	25%	30%	15%
EBITDA	$34	$43	$51	$47	$61	$23
EV/EBITDA Multiple at $3.36	**13.2**	**10.5**	**8.8**	**9.6**	**7.3**	**19.5**
Net Debt / EBITDA	**2.9**	**2.3**	**1.9**	**2.1**	**1.6**	**4.3**
Price	3.36	3.36	3.36	3.36	3.36	3.36
Shares	103.7	103.7	103.7	103.7	103.7	103.7
Market Cap	$349	$349	$349	$349	$349	$349
Net Debt	$98	$98	$98	$98	$98	$98
Enterprise Value	$447	$447	$447	$447	$447	$447

Mike Regan can be reached at **miker@mjbizdaily.com**.