

**SNAPSHOT**

# CALIFORNIA: One Year In

**A comprehensive look at the strengths and weaknesses in California's newly regulated cannabis market – and what to watch in the months ahead.**





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# CALIFORNIA MARKET REPORT: ONE YEAR IN



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Welcome to the first California report produced by the research team at Marijuana Business Daily.

California entered a new era in January 2018 with the rollout of its newly regulated cannabis market for both medical and recreational marijuana, technically ending a 22-year gray market that followed voter approval of medical MJ in 1996 and adult-use legalization in 2016.

But in reality, the gray and black markets continued to not only exist but thrive as licensed companies struggled throughout last year with new state and local regulations, new taxes that drove prices sky high and turned many consumers back to the underground market, and a supply chain that is still finding its footing.

The first full year of legal recreational sales also brought hefty compliance costs for growers, retailers, manufacturers and every other type of plant-touching company. The dual licensing structure - which requires companies to first have some kind of authorization from their home city or county before obtaining state licenses - also led to a major market contraction, with thousands of firms being shut out of the legal market because of local MJ business bans or license caps.

The upshot for 2018 was immense business turbulence and little to no profits for many plant-touching companies.

That means businesses trying to enter the California market must do serious due diligence on the cities or counties in which they want to operate to ascertain:

- Whether licensing opportunities exist.
- What the related costs are.
- What the timeline for submitting a license application may be.
- Making sure there's even real estate available for a given business type.

In short, there's no easy way to navigate California's cannabis landscape.

This report aims to provide a snapshot of where upcoming business opportunities may be, where the market may already be saturated, how many companies are already in the space and other pertinent information that can help entrepreneurs develop their plans.

This report will provide a high-level overview of the plant-touching sectors in California, including:

- Retail
- Cultivation
- Manufacturing
- Laboratory testing
- Distribution
- Microbusiness
- Regional distribution by license type
- Cities and counties that may have future licensing opportunities

If you have any questions or want to provide feedback, please contact us at [johns@mjbizdaily.com](mailto:johns@mjbizdaily.com) and [elim@mjbizdaily.com](mailto:elim@mjbizdaily.com).

Best regards,

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Research Editor



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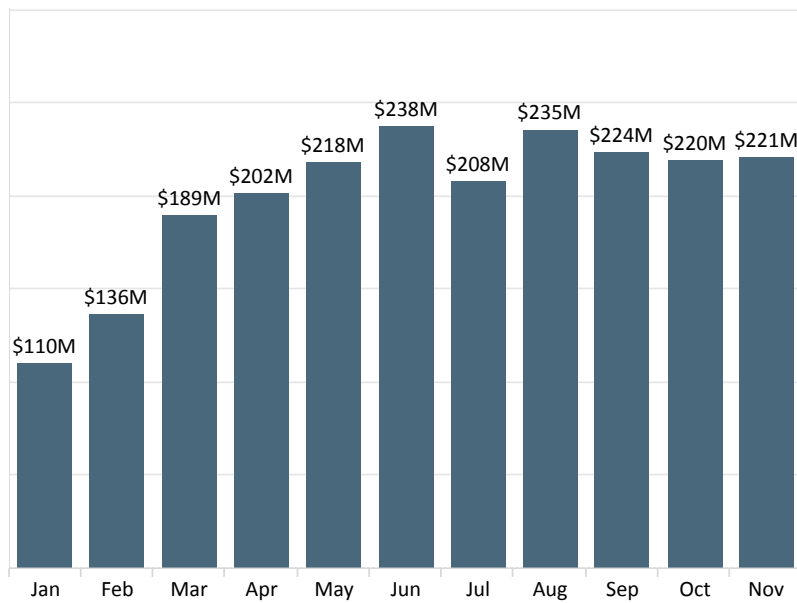


# CALIFORNIA MARKET OVERVIEW: WHAT YOU NEED TO KNOW ABOUT THE CALIFORNIA MARKET

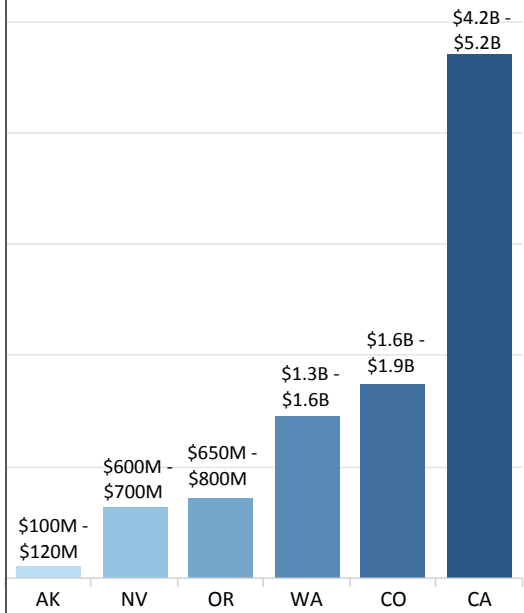
## IT'S THE LARGEST MARKET IN THE WORLD

### California Retail Marijuana Sales Overview

Monthly Sales Through Licensed Retail Stores in 2018



Estimated Retail Sales in 2020 by State  
(Medical & Recreational Markets Combined)



Source: BDS Analytics, Marijuana Business Daily

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With almost 40 million residents and the longest-running medical marijuana program in the country, California is easily the largest cannabis market in the United States and will continue as top dog for the foreseeable future.

The Golden State logged more than \$2.2 billion in sales through state-licensed channels in the first 11 months of 2018 [Data for December was not available as of press time for this report]. That number is expected to grow over time, as the illicit market shrinks with consumers migrating to fully legal retailers and wholesale prices trending downward.

By the end of 2020, estimated retail sales for both medical and recreational marijuana could top \$5 billion.

The market is still very much developing, as legacy operators from the decades-old black market and the younger medical gray market continue to transition into the newly regulated system, while out-of-state companies simultaneously try to stake their claim.

That means that while competition for market share in California will be intense, there's also a really big pie to split among those willing to fight for it.

During 2019, many insiders expect a high attrition rate, as undercapitalized businesses that obtained quick-and-easy permits in 2018 began to fall by the wayside during the much stricter annual licensing process, which will be cost-prohibitive for many entrepreneurs.

What that adds up to is the largest marijuana market in the world is - arguably - still up for grabs.



A close-up photograph of cannabis leaves, showing their characteristic serrated edges and intricate vein patterns. The leaves are a vibrant green color, and the background is dark, making the foliage stand out. The lighting highlights the texture of the leaves, creating a sense of depth and detail.

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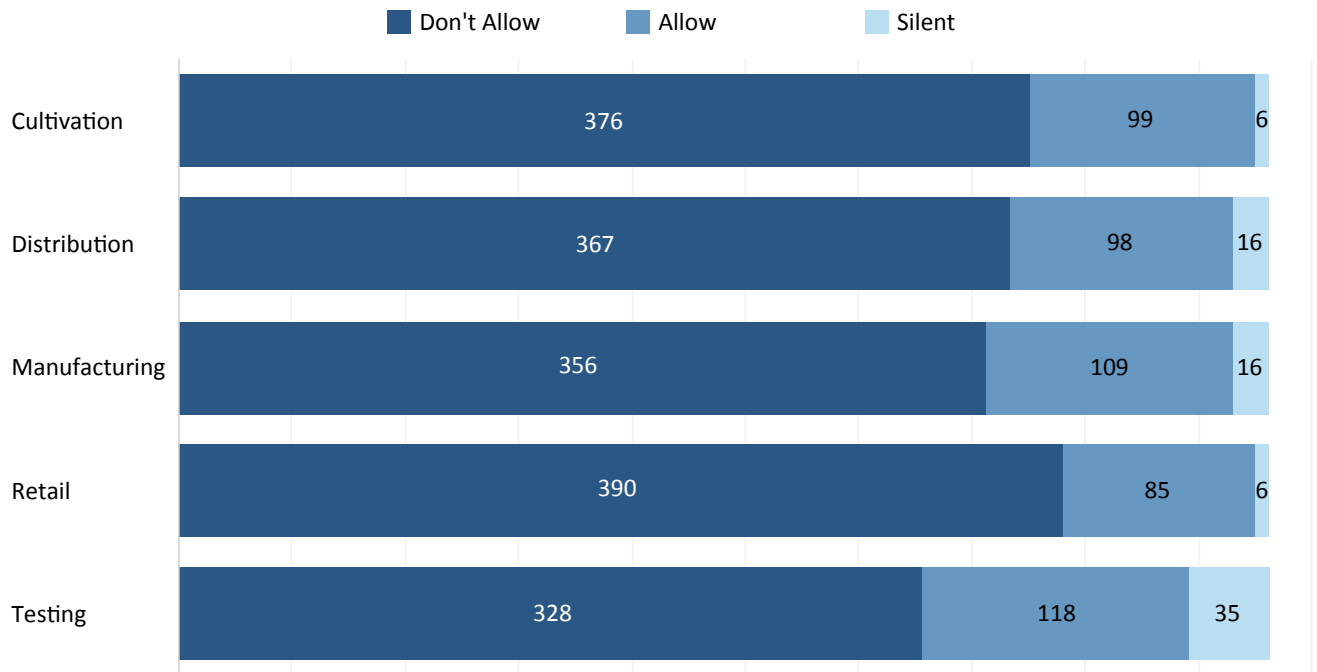
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## RULES & REGULATIONS VARY BY MUNICIPALITIES

### Status of Recreational Marijuana Commercial Activity Rules in California by City



Source: CannaRegs

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Not many jurisdictions allow the marijuana industry in the Golden State. Only 161 of California's 482 municipalities and 24 of the 58 counties have opted to allow commercial cannabis activity of any sort, according to data from CannaRegs, which tracks local marijuana rule developments in the state.

Many of those local jurisdictions also allow only a particular type of cannabis business, such as testing labs, or just medical marijuana companies and not recreational.

This means that getting into the California market isn't as simple as walking into San Francisco or Los Angeles and filing paperwork to start a marijuana shop. The state remains a patchwork of regulations and rules, with most local jurisdictions choosing to implement their own regulatory schemes on top of the state rules.

Part of the transition into a state-regulated system has also meant that tens of thousands of legacy operators who fueled California's gray medical marijuana market for two decades have been shut out of the legal market, either by local license caps or by city or county bans on their business models.

Many of those pioneers were small companies, often one-person operations, that don't have the resources to relocate into a city or county that will grant them permits to continue doing business in the legal marijuana sector. That has led to enormous market contraction, while simultaneously opening distinct windows for business opportunities down the road.



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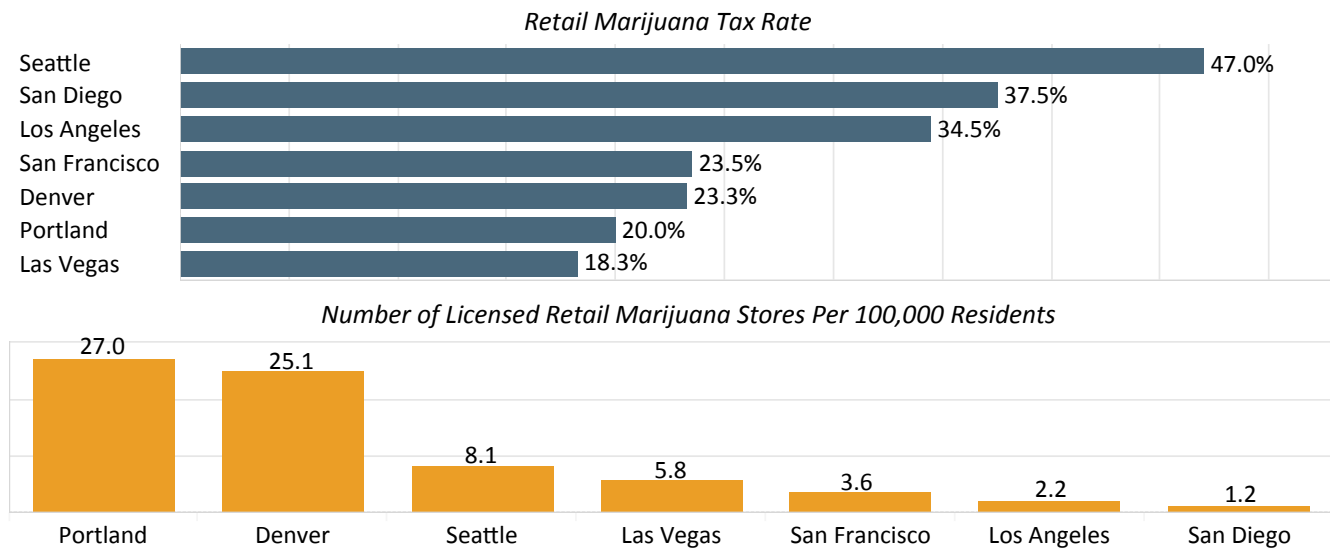
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## THE BLACK MARKET CONTINUES TO HAVE A MAJOR PRESENCE IN THE STATE

### Marijuana Tax Rate & Number of Retail Stores Per Capita: How California Cities Compare with Other Major Markets



Note: Retail tax rate includes excise, state and city taxes on the sale of retail marijuana. Any additional taxes applied at the wholesale level are excluded.

Source: Los Angeles Times, FlowHub, Colorado Department of Revenue, Oregon Liquor Control Commission, Nevada Department of Taxation, Washington State Liquor & Cannabis Board

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Broadly speaking, most cities and counties have a limit on how many marijuana businesses they allow to set up shop. Many of the business opportunities in California were immediately snapped up in 2018 by existing companies transitioning into the legal market.

Some estimates come in north of 100,000 different marijuana companies – including one-person operations such as small edibles makers or growers that fed the state supply chain – that operated in California’s gray medical market before 2018.

In the Emerald Triangle – the counties of Humboldt, Mendocino and Trinity in Northern California that have supplied the U.S. black market for decades – there were roughly 68,000 small cannabis farms, according to an estimate by the California Growers Association in early 2018.

But as of January 2019, there were only roughly 5,000 state-licensed businesses authorized by the state.

The thousands of other companies that haven’t obtained licenses didn’t simply vanish or leave the industry. Rather, they kept operating in one way or another.

Illegal storefronts continue to be a major problem in the Los Angeles area, for both law enforcement and licensed retailers that are paying state and local taxes only to watch unlicensed competitors undercut them on product prices. In Northern California, illegal storefronts are less of a problem but unlicensed delivery businesses flourish, as do so-called underground “smoke sessions,” where consumers and growers meet up to buy and sell cannabis that hasn’t gone through the legal supply chain.

High state and local taxes have continued to drive consumers to the underground market as well. The state charges a 15% excise tax and cultivation taxes of \$9.25 per ounce of flower, \$2.75 per ounce of leaves and \$1.29 per ounce of fresh plant material, along with whatever local taxes are tacked on by a city or county. Black-market operators skip those charges.

In short, the black market is still a very real competitor for licensed companies, especially smaller ones that may not have the capital to withstand slim or nonexistent profit margins for months or years while the market stabilizes.



## LICENSES WILL BE HARDER TO OBTAIN

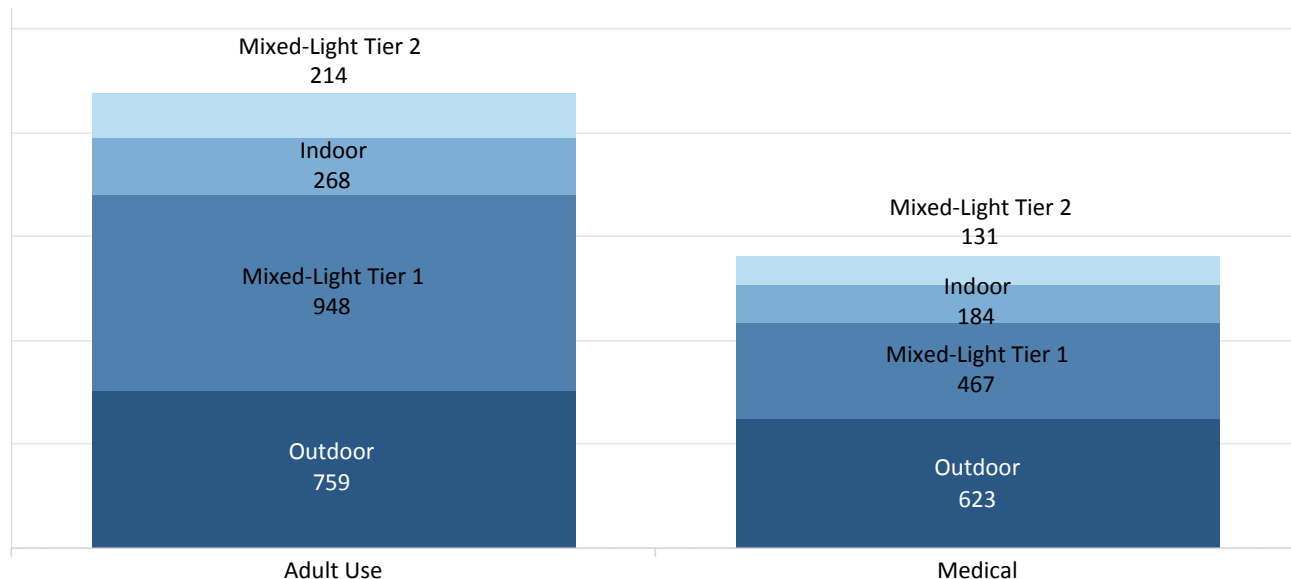
### Sampling of Information Needed to Obtain Marijuana Business License in California: Temporary Licenses Compared with Annual Licenses

	Temporary License	Annual License
Require Lease or Proof of Property Ownership?	✓	✓
Require Seller's Permit?	✓	✓
Require Inventory Control Plan?	✗	✓
Require Personnel Plan?	✗	✓
Require Insurance Information?	✗	✓
Require Fire Safety Plan?	✗	✓

Source: Margolin & Lawrence Attorneys at Law

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### Pending Applications for Annual Cultivation Licenses in California: Breakdown by Market & Grow Type



**Average Time to Process Application: 3.5 - 8 months**

Source: California Department of Food and Agriculture

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There may also be further market contraction this year, given that every business in the supply chain in 2018 was operating under temporary state permits that were fairly easy to acquire, as long as a given company had approval from its home city or county. One state industry expert predicted a 90% contraction rate over the course of the year, but many of those companies may be acquired as opposed to closing their doors.

The state stopped issuing temporary licenses at the end of 2018, and any company without one will now have to apply for a full annual permit - a much more difficult threshold to hit, because that encompasses site inspections by various agencies, stricter zoning and environmental compliance and more. Which also means many of the companies with temporary licenses may not be in business at the end of 2019 if they don't get approval for an annual permit.

It also takes months to obtain annual permits from the three state agencies that oversee businesses. Some that submitted their annual applications in mid-2018 were still awaiting final approval as of February 2019. That lag time, which may vary widely from company to company, can be costly. Businesses must obtain sites on which to operate and then get an annual permit before they will legally be able to get up and running.

## FUTURE BUSINESS OPPORTUNITIES

There will be opportunities in 2019 and beyond to jump into the California market, but the key will be finding localities that accept business license applications - and most have a short window in which to file applications. Even then, winning a business license is far from certain, because the process is typically competitive with just a limited number of licenses available per city or county.

According to CannaRegs, the cities and counties accepting license applications in early 2019, or that are in the process of crafting application procedures, include:

- Alameda
- American Canyon
- Chula Vista
- Firebaugh
- Fresno
- Jurupa Valley
- Mountain View
- Novato
- Pasadena
- Placerville
- San Luis Obispo
- Solvang
- Vista
- Nevada County
- Riverside County
- San Benito County

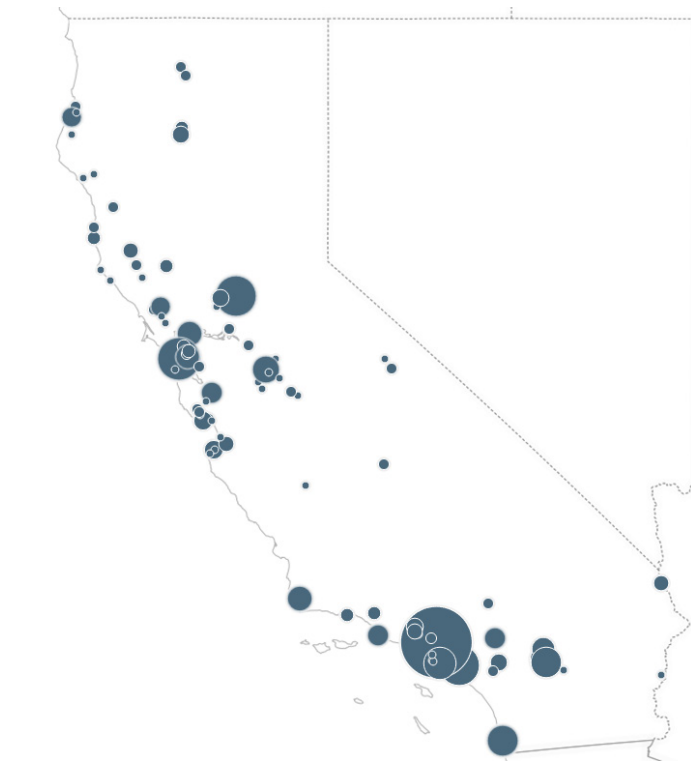
For many of those, especially smaller towns, the application window may be as small as a few weeks or a month. So, it's important for new market entrants to keep up to speed on which localities will be licensing and when.

The city of Los Angeles, perhaps the biggest market in the world, is also slated to open a licensing round to the general public sometime in 2019, but as of mid-January the city's Department of Cannabis Regulation had not announced when that would happen.

There are likely to be more localities that decide to permit cannabis companies as time goes on, said CannaRegs founder and CEO Amanda Ostrowitz. But it's impossible at this point to predict how many and when, because local cannabis ordinances are tricky political animals that are negotiated on a case-by-case basis with city councils, county boards of supervisors and other stakeholders.



# RETAIL AND DELIVERY



Number of Licenses [retail]	
Adult Use Only	37
Medical Only	78
<b>Combined</b>	<b>520</b>

Number of Licenses [delivery]	
Adult Use Only	34
Medical Only	26
<b>Combined</b>	<b>255</b>

Top Cities [all retail license types combined]	
Los Angeles	88
San Francisco	33
Sacramento	29
Santa Ana	29
Long Beach	26

Top Cities [all delivery license types combined]	
Oakland	123
Sacramento	60
San Francisco	28
Commerce	12
Montebello	12

One of the more common refrains among companies in the California supply chain in 2018 was the need for more licensed retailers. But the immediate obstacle is the dual licensing requirement, which leaves the number of brick-and-mortar retail outlets to California's cities and counties.

That situation will likely loosen as time goes on and more communities decide to opt into the industry, given the obvious tax income benefits they stand to reap, but it's still an immediate hurdle that isn't easily overcome.

To get around that obstacle, many companies are considering delivery. California is one of the few U.S. states that has fully embraced MJ delivery as an alternative to requiring sales be made at physical storefronts. It is a booming business in the Golden State and is poised to become an even more critical industry component in 2019.

The Bureau of Cannabis Control (BCC) – the state agency that licenses and regulates all cannabis retailers – issued a policy in mid-2018 that allows for marijuana to be delivered anywhere in the state, regardless of local bans on MJ companies.

That means the question for new market entrants would be where to headquarter a delivery business and how to gather enough capital to subsidize a fleet of transport vehicles to cost effectively deliver to as wide a region across the state as possible.

## WHAT TO WATCH

The long-term viability of statewide MJ retail delivery remains to be seen, but for the short term, it appears to be a solid way into the California market.

The BCC statewide delivery policy may be challenged in court in 2019 by the League of California Cities or individual anti-cannabis localities that want to keep their total bans in place. There were rumblings of court challenges starting in mid-2018 after the BCC first announced the statewide delivery policy regardless of local MJ business bans.

It will also be worth watching whether the state Legislature cracks down in a serious way on the black market or if lawmakers take steps to give licensed operators a competitive leg up, perhaps by lowering state taxes temporarily or by devoting more resources to eradicating the underground market.

# CULTIVATION

## Number of Licenses

6,930

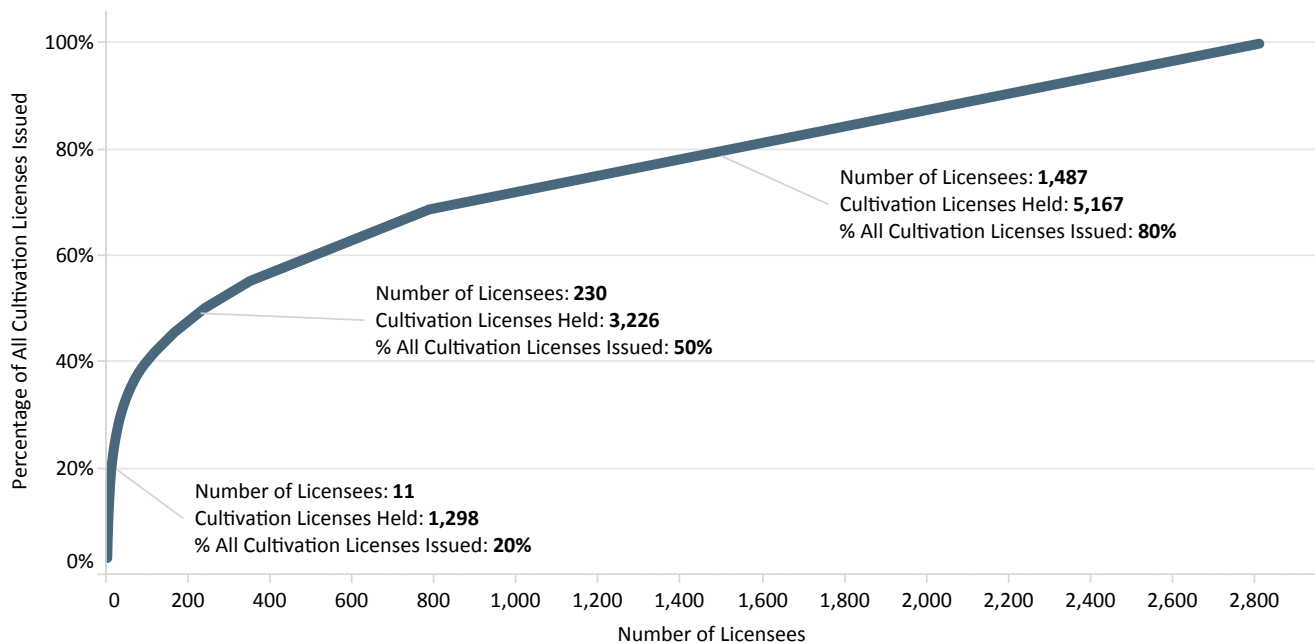
## Number of Licensees

2,810

## Top Counties by Number of Licenses

Santa Barbara	2,127
Humboldt	1,478
Mendocino	694
Monterey	484
Los Angeles	393

## Distribution of California Cultivation Licenses By Number of Licensees



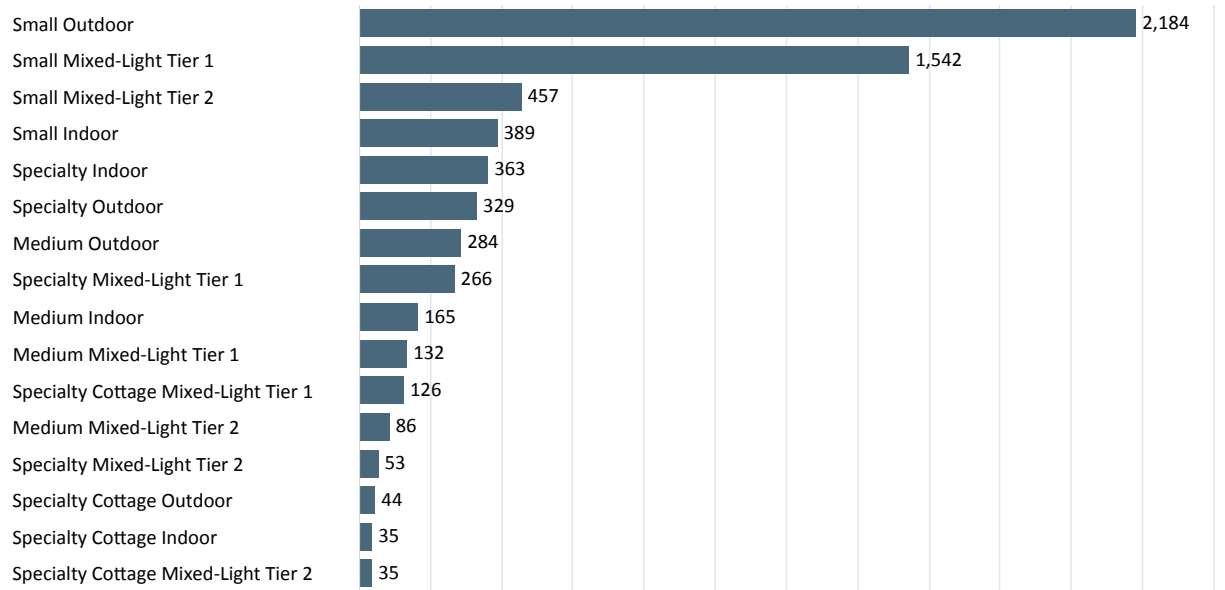
Source: California Department of Food and Agriculture

Note: Processors and nurseries excluded from licensing data.

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## Distribution of California Cultivation Licenses By Type



Source: California Department of Food and Agriculture

Note: Processors and nurseries excluded from licensing data.

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Growing is easily the most saturated of all the cannabis sectors in California, with a whopping 6,930 temporary licenses held by 2,810 licensees as of January 2019.

Growing cannabis in California is a complex proposition from the outset, with 14 different license types to choose from, including “mixed-light,” or greenhouses that utilize both the sun and artificial lights.

License types include:

- Specialty cottage outdoor: maximum 25 plants allowed
- Specialty cottage indoor: Up to 500 square feet of canopy
- Specialty cottage mixed-light: Up to 2,500 square feet of canopy
- Specialty outdoor: Up to 5,000 square feet or up to 50 mature plants on noncontiguous plots
- Specialty indoor: Between 501 and 5,000 square feet of canopy
- Specialty mixed-light: Between 2,501 and 5,000 square feet of canopy
- Small outdoor: Between 5,001 and 10,000 square feet of canopy
- Small mixed-light: Between 5,001 and 10,000 square feet of canopy
- Medium outdoor: Between 10,001 square feet and one acre of canopy
- Medium indoor: Between 10,001 and 22,000 square feet of canopy
- Medium mixed-light: Between 10,001 and 22,000 square feet of canopy
- Nursery: A cultivation site that specializes in immature plants and material, such as cloning and seed propagation
- Processor: A cultivation site that conducts trimming, drying, curing, grading or packaging of nonmanufactured products

Three “large” license types won’t be available until 2023:

- Large outdoor: More than 1 acre of canopy
- Large indoor: More than 22,000 square feet of canopy
- Large mixed-light: More than 22,000 square feet of canopy

The most common cultivation license type is “small outdoor,” which allows for up to 10,000 square feet of plants. There is no limit on how many of those licenses can be acquired by a single company. “License stacking” – where a single company obtains multiple licenses for a single grow site – has become common in many parts of California, essentially allowing for as much grow space as a company’s budget can support. There are already immense commercial-scale grows built out – especially in Southern California – because of license-stacking.

Medium grow licenses, by contrast, are limited to one per company.

## WHAT TO WATCH

A big question in the California supply chain is whether smaller growers – which comprise most of the Emerald Triangle in Northern California – will be able to compete with huge license-stackers, which are congregated mostly in Santa Barbara County. In 2018, Santa Barbara issued more cultivation permits than any other county in the state, followed by Humboldt County, one of the traditional homes of cannabis growers and a longtime source for the nation’s black-market marijuana.

Many smaller farmers that have been growing cannabis for years or even decades in the Emerald Triangle have been worried that they won’t be able to compete on wholesale prices with larger-scale cultivation sites, because license-stacking allows those growers to take advantage of scaled cost efficiencies that lower their overall price of production. That was why the ban on “large” grows was included in the law – small farmers lobbied for it, to give themselves time to gain as much market share as possible before the entrance of bigger, more well-capitalized competitors.

But whether there’s enough market demand for “craft” cannabis in order to make small farms viable in the long term has yet to be seen.



# MANUFACTURING

Number of Licenses	
Adult Use Only	24
Medical Only	183
<b>Combined</b>	<b>1,039</b>

Top Cities (all license types combined)	
Los Angeles	134
Oakland	120
Long Beach	73
Sacramento	53
Desert Hot Springs	52

The California cannabis manufacturing sector is particularly wide-ranging and encompasses much more than just traditional edibles such as brownies and gummies.

It applies to any company involved in extraction and production, which includes hugely popular disposable vaporizer cartridges, concentrates such as shatter, topicals such as lotions and creams, and more.

This is a sector that has seen a lot of innovation in recent years, as companies experiment with different product types and ways to bolster product potency, since topicals – including tinctures, sublingual strips, oral sprays, etc. – aren't subject to the same potency restrictions as traditional edibles, which are limited to 100 milligrams of THC per package for both recreational and medical customers. Recreational topicals, by contrast, may contain up to 1,000 milligrams per package, and medical topicals can contain up to 2,000 milligrams per package.

The key in manufacturing is product consistency and building brand loyalty, especially with so many competing brands. Most customers don't have the time or money to try out all the different products on the market.

Another significant factor is the extraction process, since a lot of manufacturers rely on volatile solvents, a process that is also prohibited in many California jurisdictions that already allow MJ manufacturing. That can be worked around, but it's a question of finding a city or county that will sign off on a business plan, so manufacturing processes can be key.

## WHAT TO WATCH

Manufacturing is where there will be the most product innovation, and it's probably the area that could be the most rewarding to innovation. Traditionally, there has been a lot of variance in manufactured cannabis product consistency, reliability and potency, so companies that focus on delivering those to consumers are more likely to thrive than those that rely on marketing gimmicks.

# DISTRIBUTION

Number of Licenses	
Adult Use Only	128
Medical Only	243
<b>Combined</b>	<b>1,030</b>

Top Cities (all license types combined)	
Los Angeles	134
Oakland	139
Long Beach	56
Sacramento	49
Adelanto	39

Although California has more than 1,400 distributors – more than licensed retail shops, delivery operators and retail microbusinesses – this sector could be a prime area for new market entrants as the industry continues to develop.

Not only is California a huge state that requires basic transportation services for cannabis products, but distributors also often act as brand ambassadors and play a key role in collecting required state taxes on products.

It's also common for a single distribution company to work with just a handful of brands or clients, as opposed to a wholesaler that acts as a one-stop-shop for retailers.

That means there's a lot of built-in flexibility for distributors that want to adapt their business models. One of the premier Northern California distributors, Flow Kana, has centered its model on small farmers in the Emerald Triangle that want to continue growing marijuana as they have for years but have no interest in branding, marketing or general business dealings. Flow Kana acts as a collection point for cannabis produced by those farms and takes care of relationships with retailers and others downstream in the supply chain.

Other distributors focus solely on the booming disposable vaporizer cartridge sector, while yet others try to be that one-stop-shop for retailers looking for flower, edibles and concentrates with which to stock their shelves.

As of September 2018, there were zero distributors in Trinity County, which led to the very real possibility of thousands of pounds of cannabis being left out of the legal market simply because farmers there had no way to get their products to market.

That means there's probably ample opportunity for new market entrants in the distribution arena.

## WHAT TO WATCH

One of the biggest responsibilities held by California cannabis distributors is the collection and remittance of state marijuana taxes, an area where many companies have been falling short for unknown reasons, according to one industry source who scrutinized the state cannabis tax receipts.

That means there could be auditing trouble on the horizon for many existing distributors. It also means incoming companies should do serious due diligence to ensure they fully understand what the obligations of distributors entail.

# TESTING LABS

## Number of Licenses

52

## Top Cities (all license types combined)

Long Beach	4
Los Angeles	4
San Diego	4

If there's a single sector in the California marijuana business that's lacking, it's testing labs.

As of January 2019, there were 52 state-licensed labs, but not all of them were operational and only a handful were performing mandatory testing for heavy metals under an industry regulation that went into effect on Jan. 1, according to industry sources.

Industry insiders suggested throughout 2018 that the supply chain is so immense that the state could easily use several hundred testing labs, instead of a few dozen, just to ensure that routine testing goes smoothly and products can be delivered to market on a predictable timeline.

But lab testing is also arguably the hardest sector to break into, simply because of the high costs and experience required to start such a venture. Necessary equipment can easily run into the hundreds of thousands of dollars, staffing can cost just as much for experienced lab technicians and well-educated scientists, and the testing processes themselves can be a maze to figure out.

Labs need to be proficient in testing for a range of possible contaminants such as heavy metals and pesticides – not just THC potency. And the industry still has not adopted universal testing standards, which has led time and time again to disparate analysis and dissatisfied customers in the supply chain.

Licensed labs are prohibited from holding any other type of marijuana business license, to avoid conflicts of interest. Other types of companies have plenty of license crossover, such as vertically integrated retailers that also have small cultivation licenses or manufacturing permits.

## WHAT TO WATCH

There was a major shortage of testing labs as of early 2019, and because so few were conducting heavy metal testing, turnaround times at labs could increase the same way they did in July 2018, when pesticide testing became a requirement for all legal marijuana in California.

As of February 2019, many in the supply chain still relied on product that had already passed testing in 2018; retailers stocked up so they wouldn't have to risk running out of legal and tested cannabis because of potential testing backlogs. So, how quickly and smoothly Phase 3 testing is implemented is also still an open question.



# MICROBUSINESS

Total Licensees	
Adult Use Only	37
Medical Only	21
<b>Combined</b>	<b>236</b>

Number of Licenses by Business Type	
Retail	105 [36% of microbusinesses hold retail licenses]
Delivery	89 [30% of microbusinesses hold delivery licenses]
Cultivation	216 [73% of microbusinesses hold cultivation licenses]
Manufacturing	272 [93% of microbusinesses hold manufacturing licenses]
Distribution	290 [99% of microbusinesses hold distribution licenses]

Microbusiness is a license type pioneered by California and designed for small companies that want to have a broad business model. The downside is that it requires companies to possess at least three of the four following license types: retail, cultivation, manufacturer and distributor.

That can be a blessing or a curse, depending on how much capital, staffing and flexibility a company has, given that each of those areas can be incredibly complex to navigate on their own.

As of January 2019, there were 294 licensed microbusinesses in California.

One of the bigger upsides to being a microbusiness is vertical integration. The argument in favor of such a model is that microbusinesses largely don't have to rely on outside distributors or the supply chain in general; they can act as their own supplier, albeit on a much smaller scale than the many licensed retailers they compete with.

That means no uncertainties on when product may be delivered or if it'll pass testing, direct control over manufacturing processes as well as packaging and labeling, and control over what types of products or strains the microbusiness wants to specialize in.

The barriers to entry, however, are similar to those faced by retailers, including the biggest – finding a legal home in a California city or county that's willing to accept the industry.

Microbusinesses also don't lend themselves to expansion as much as some of the other license types and are much more geared toward entrepreneurs that want to have a relatively small or vertically integrated footprint.

## WHAT TO WATCH

Microbusinesses are a real niche in the California marijuana space, but the requirement that they be at least somewhat vertically integrated could lead to an upswing in the number of such licenses and, perhaps, even a downturn in how many separately licensed cultivators there are.

Developments along those lines could also depend greatly on just how more cities and counties in California decide to allow MJ companies to set up shop within their borders. Smaller companies such as microbusinesses could be more welcome than larger corporations, or the trend could be reversed.