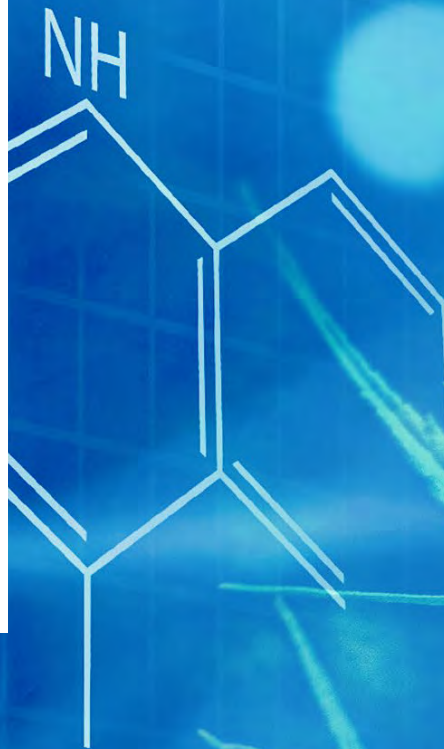




C L I F F O R D
C H A N C E



Cannabis –
a new high
for Germany



Two leading advisors to the cannabis industry and to investors in the space offer their thoughts on the impact the upcoming German legislative changes on recreational cannabis will have.

The dedicated Healthcare & Life Sciences Group at **Clifford Chance** has been awarded Law Firm of the Year 2020/2021 for Regulated Industries (JUVE) due to its outstanding expertise in the cannabis legal space, adding to the list of recent accomplishments ranking “Tier 1” for healthcare and life sciences (Legal 500), for transactions in the pharmaceutical sector (JUVE) as well as for pharmaceuticals and medical devices law (JUVE). Clifford Chance has built a unique track record in advising clients from a broad range of industry sectors (including financial and strategic investors, banks, manufacturers, distributors, cultivators and wholesalers, retailers, and e-commerce platforms) on cannabis and cannabis-based products. Recent examples include advising:

- Sanity Group on the largest ever European series A round for cannabis-based products.
- Global private equity firm Permira on the acquisition of leading European CNS specialty pharmaceutical company Neuraxpharm with its medical cannabis portfolio.
- A global investment bank as an underwriter with respect to the envisaged IPO of a leading healthcare company with a portfolio including cannabis-based products portfolio.
- A global payment services provider and a leading international bank on the legal framework for cannabis-based products and related payment processing in all European countries.

Carlsquare – the No. 1 M&A advisor in Germany¹ – has previously assisted the owners of Canobo, the leading CBD brand in Germany, in raising funds from specialist cannabis financial investor Altitude Investment Management. They’ve also advised it on a potential transaction with Sydney-listed global player Elixinol and, more recently, advised the No. 1 e-commerce CBD brand house in the UK, “Blessed”, on a sale to the Canadian listed cannabis company High Tide Inc. Carlsquare is currently advising a leading integrated player in the cannabis market in Germany on a combined majority sale and fundraising to finance a nationwide roll-out of a chain of cannabis dispensaries.

EXECUTIVE SUMMARY:

We believe that it will still take some years to implement suitable legislation and create an appropriate market environment to make recreational cannabis available in sufficient amounts to meet market demand in Germany. In a similar way to Switzerland, we suspect that Germany will try to justify the legalisation of recreational cannabis with higher legal and drug policy goals in view of the 1961 UN Single Convention on Narcotic Drugs. Distribution will presumably be initiated through pharmacies and then potentially extended to dedicated and licensed dispensaries after a transition period of several years. The pricing for legalised recreational cannabis will be competitive in comparison to prices on the black market in order to ensure that the key principles behind the legislation,

¹ Mergermarket sell-side ranking for the last two years (2020 and 2021).

namely maintaining health and safety and protecting young people, will be upheld. Given that distribution will likely start through the pharmacy channel, we believe that the main beneficiaries will be those players who sell via pharmacies already, as well as those who can quickly jump on and adapt to this distribution channel. The North American players wanting to play a part in the largest market for cannabis in Europe would do well to look at the parties already distributing via pharmacies and at those with the wherewithal to roll up a nationwide network of dispensaries in the mid to long term.

What the agreement between the SPD, the Greens and the FDP says:

*“We will introduce the **controlled** distribution of cannabis to adult end-consumers for recreational use in **specialty licensed shops**”* (source: “Coalition agreement” of Nov. 26, 2021, translation by the authors, emphasis added)

The new German government therefore also intends to legalise the supply of **cannabis for recreational use in Germany** within the current legislative period. However, one of the key issues will be how to cultivate and supply the requisite volume of cannabis products under Germany’s current legal framework. The reasons cited by the German government for its legalisation plans are maintaining health and safety (e.g. by regulating the ingredients and THC content of cannabis products for recreational use) and protecting young people (e.g. by running more prevention and awareness projects). The distribution of cannabis products for recreational use is also intended to take place only through licensed suppliers to

ensure the individual products can be traced and verified, and consumers given appropriate advice. The plan is to re-evaluate and review the project four years after legalisation to see if it is suitable for implementation over the long term.

While the future legislation and regulation for the legal distribution and sale of legalised cannabis for recreational use is hotly debated behind closed doors, the authors will attempt to look to the future impact of possible legislative changes, outlining possible scenarios and describing their impact. We will initially discuss the supply chain side of the equation and then potential future issues related to the distribution of recreational cannabis. As experienced M&A and regulatory practitioners in the field, we try to gauge the impact of possible legislative changes on the availability of financing and valuation of players in the cannabis space.

UPCOMING LEGISLATION: SUPPLY CHAIN ISSUES

What we know:

A key issue, which has not yet been the subject of a great deal of general discussion, is the impact of regulatory change on the supply chain for recreational cannabis. Based on initial calculations, the relevant **demand in Germany will be – roughly – 400 tonnes per year** after legalisation. Currently, however, only 2.6 tonnes are cultivated for medical purposes. Although licensed cannabis growers in Germany have said they will be able to increase production at short notice and the German Minister of Agriculture has already announced that he wants to involve German farmers in the cultivation of



cannabis, neither existing growers nor additional cultivation will be able to meet the forecast demand of roughly 400 tonnes per year at short notice, meaning that Germany would have to **rely on importing cannabis for recreational use.**

The **1961 United Nations Single Convention** on Narcotic Drugs, however, expressly **prohibits the import of cannabis for recreational use.** On that basis, recreational cannabis could only be purchased from German producers, so **only a tiny fraction of the actual demand could be met.**

Given this, a key issue will be where the recreational cannabis is going to come from if the supply grown in Germany is not even sufficient to satisfy the demand for medical cannabis and imports are not allowed under the 1961 United Nations Single Convention on Narcotic Drugs.

Other countries that have also ratified the 1961 UN Convention and are planning to or have already implemented the legalisation of recreational cannabis are facing similar challenges. Switzerland, for example, is currently planning a pilot project and trying to justify potential conflicts with the 1961 UN Convention with higher goals of establishing a health-orientated international drug policy based on human rights in the long term.

In contrast, the model currently practised in the Netherlands of merely tolerating the use of cannabis for recreational purposes could not be implemented in Germany because the German authorities are obliged by law to prosecute all criminal offences. This includes the organised sale or trade of recreational cannabis, as long as it is classified as a prohibited narcotic drug within the sense of the 1961 UN Convention.

While we cannot yet say how this conundrum will finally be resolved, we think it likely that Germany will follow the Swiss rather than the Dutch model and thus **try to justify the legalisation of recreational cannabis with higher legal and drug policy goals.**

UPCOMING LEGISLATION: PRICING ISSUES

It is still largely unclear how pricing for recreational cannabis products will work. One conceivable option is for **no legal requirements to be put in place** at all – which seems to be what **most market participants expect.** However, some regional pharmacist organisations are already putting forward **proposals for fixed prices.**

What is clear is that the pricing must be **competitive in comparison to prices on the black market** in order to ensure that the key principles behind the legislation, namely maintaining health and safety and protecting young people, are upheld. If black market prices for recreational cannabis products were considerably lower than official prices, it could not be assumed that the majority of consumers would switch to buying from legal sources, thus thwarting a key



objective of the legalisation of cannabis for recreational use in Germany.

So, to achieve the stated purpose of “drying out the black market”, the after-tax retail price must be in line or – at least initially, as the distribution systems and the licensing regime is



put in place and availability is limited – be significantly below the “street price” of roughly EUR 10 per gram on average.

UPCOMING LEGISLATION: DISTRIBUTION ISSUES

What we know:

- The German coalition partners agreed to introduce a set of legislative proposals which will govern how the intention “to legalise cannabis for recreational use” will be implemented.
- For a trial period lasting four years, cannabis will be distributed to adult end-consumers via “specially licensed shops”.
- The existing legislation regarding CBD and medical cannabis remains intact and untouched by this agreement.

What we infer or speculate:

One of the central questions for the distribution of recreational cannabis in Germany will be the licensed shops through which the products can be dispensed. Distribution via pharmacies, via licensed retail dispensaries or via **a newly created category of licensed cannabis shops** could be considered. In short, we believe that recreational cannabis regulation will take its cue **from the regulation in place for pharmacies**, and that consequently recreational cannabis will be **initially available at pharmacies only** and – possibly after a transition period of several years – also or exclusively **at dedicated dispensaries**.

It is debatable whether the initial distribution of cannabis for recreational use through pharmacies would be compliant with German pharmacy law. A key purpose of pharmacies – according to the law – is the dispensing of medicinal products and medical devices that require a pharmacist’s advice, as well as the provision of health-related information on these products. Thus, recreational cannabis does not fit well with this core purpose for pharmacies. At the same time, some pharmacists’ associations in Germany have already identified a potential new lucrative business and claim that only pharmacists can reliably advise on the responsible use of cannabis. The Federal Union of German Associations of Pharmacists (ABDA) is referring to a “conflict of healthcare objectives” because, although pharmacists are not supposed

to supply narcotic drugs for recreational use, if cannabis was to be legalized for such purposes in Germany and a safe distribution system was required, pharmacists would be better placed than anyone else to offer such a system.

Which scenarios do we see?

Essentially two, but there could be a mix or a transition from one to the other: a transitory or permanent distribution via pharmacies and/or a stand-alone or dual scenario with “specially licensed shops”. “Specially licensed shops” could be subject to a rather tough regulatory system where the licence regulation is going to be similar to the rather strict requirements which pharmacies or drug dispensaries are required to meet in Germany.

With it not being possible to roll out such strictly regulated dispensaries on a large scale in the short term and to staff them with sufficiently qualified personnel, we consider it conceivable that, at least for a transitional period, recreational Cannabis could also temporarily be dispensed exclusively via pharmacies. Since the entire legalisation project is to be re-evaluated after four years, it also cannot be ruled out that the Federal Government and German legislators might then even come to the conclusion that pharmacies – should they initially be included in the distribution of recreational cannabis – may be very well suited for this purpose. Further consideration could then be given to having future distribution not being organised exclusively via specially licensed shops, but in a kind of dual distribution system via both pharmacies and licensed dispensaries. Whether e-commerce providers and direct delivery services will also benefit from the legalisation of recreational cannabis in Germany will depend on whether, and to what extent, e-commerce and delivery services will be permitted (e.g. domestic versus cross-border) and where the relevant service providers will be based (i.e. inside or outside Germany).

Given the similar target groups and supply chain, we believe that the market for recreational cannabis will be dominated by existing participants in the CBD market, which also deliver to pharmacies. We have developed three possible scenarios to inform our thinking about the likely timetables, the market in the mid-term and – most importantly from an M&A perspective – the impact on the valuation of various market participants in the CBD space. The key unknown is the regulation of the distribution system.

Tomorrow's recreational cannabis market in Germany will be dominated by players already distributing to pharmacies and with the means to build up a nationwide network of dispensaries

Assessment of the impact of upcoming recreational use cannabis distribution channel regulation on today's CBD market players:

Distribution model decided on by the German legislator	Assessment of likelihood	Assessment of impact on cannabis players today		
		"Over the counter"/ OTC-brands sold in pharmacies	CBD brands mainly available in drugstores	"Direct to consumer" (DTC)/ mail order brands
Distribution through pharmacies	Likely, as the coalition wants to see recreational cannabis distributed rather quickly, but a strict monitoring system will be required from day one	+++	+	-
Distribution through specialised physical stores, which would have to comply with a tough regulatory regime that would have to be developed and monitored	This is likely to be the dominant distribution mechanism in the long-term, but building up a nationwide network of dispensaries takes time and money	Those players with the wherewithal to build up a nationwide network of dispensaries will benefit		
Distribution through all retailers which comply with a rather light regulatory regime, comparable to hard liquor	An unlikely outcome, in our view, as the public and health experts will balk at a change in legislation which decriminalises cannabis and immediately makes it available legally at every street corner	-	+++	++

So, in summary, we are convinced that tomorrow's recreational cannabis market will be dominated by players who already distribute to pharmacies and those integrated players with the means to build up a nationwide network of dispensaries in the mid to long term. North American players not yet invested in Europe's largest cannabis market might want to take a closer look.



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Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

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