Glass House

As we delved further into the cannabis sector and engaged in discussions with a range of analysts, we were presented with two distinct recommendations: first, to channel investments into MSOs (multi-state operators) due to their perceived lower risk profile. This suggestion hinged on the notion that their larger scale would enable them to secure funding if needed, thereby ensuring their survival even in challenging times.

The second recommendation advised steering clear of California, citing a series of challenges plaguing the Golden State. These obstacles included issues such as excessive production, elevated taxes on cannabis manufacturing, fierce competition from the illicit market, inadequate regulatory oversight, and intense price rivalry.

Both recommendations didn't merely constitute a consensus; they stood as unanimous viewpoints. This prompted us to embark on a more comprehensive investigation, guided by a life philosophy that encourages exploration beyond the surface when unanimity is prevalent. Driven by this ethos, we felt compelled to delve further.

In the realm of MSOs, their larger scale compared to single-state operations isn't a foolproof guarantee of reduced risk. Rather than growing organically through efficiency gains and superior offerings, many MSOs attained their substantial size by capitalizing on the conditions of newly legalized markets, often within specific states.

It's noteworthy that most MSOs are helmed by individuals with a firmer grasp of financial markets than the nuances of cannabis. Their expansion was rooted in entering states freshly opened to cannabis consumption and production. In these emerging markets, significantly higher price points were permissible, allowing these companies to focus less on cost efficiency and innovation in product development. Their initial pricing could accommodate inefficiencies due to these nascent markets' substantial margins.

For instance, consider the case of New Jersey, where recreational cannabis was legalized in 2020, but actual sales commenced in the second quarter of the subsequent year. During this period, prices soared to around US$4,500 per pound. By contrast, California witnessed cannabis available for purchase at under $300 per pound. Consequently, an MSO producing cannabis at a cost of $1,500 per pound would initially enjoy a robust gross margin within such a state.

However, this represents just one instance of the allure that newly legalized states held for MSOs. These operators raced to establish a presence in such states where cannabis use had been regulated, capitalizing on the potential for immense profit margins. Naturally, these exceptional margins are subject to decline over time, often turning negative. This inevitable trend is witnessed across the board, with states eventually evolving into competitive markets akin to California rather than the opposite scenario. This forms the crux of the quandary concerning the MSO business model.

An equally critical aspect that some analysts consider pertains to the passion and expertise of management within single-state operators. Conversations with various industry insiders in the US have underscored a preference for products from smaller enterprises. These businesses are characterized by passionate owners deeply attuned to the market's intricacies. Their continuous quest involves cultivating unique strains and differentiated products, which resonate immensely with the public and underscore the genuine dedication propelling the industry forward.

In contrast to companies operating across multiple states, those focused solely within a single state allocate their energies exclusively to that region. This concentrated approach allows them to cultivate a stronghold within their chosen territory, intimately understand their customer base, anticipate emerging trends, and continually streamline operational costs. Their very survival hinges on such optimization.

As previously discussed, the trajectory points toward diminishing prices—a prevailing reality. Hence, channelling attention toward producers with the most efficient cost structures becomes paramount within this dynamic landscape. This strategic focus ultimately shapes the investment outcomes in this domain.

The perspective on the perceived advantages of MSOs, as outlined by the analysts we engaged with, pivots on lower risk due to their sheer size—rendering them "too big to fail." However, we propose an opposing viewpoint. When interstate commerce eventually materializes, these large entities are likely to find themselves ill-equipped to compete against producers who have adeptly adapted to lower-cost structures and spearheaded evolving trends.

A fundamental understanding of the United States federal system is crucial to contextualize this scenario. While cannabis remains federally prohibited, individual states possess considerable autonomy to legislate its use and production for both medicinal and recreational purposes. However, the existing setup prohibits interstate commerce—even between bordering states that have both legalized the substance, like California and Oregon.

The landscape lacks economies of scale as MSOs are constrained to replicate an entire operational structure within each state. Suppose a company seeks to engage in vertically integrated activities in states like California and Florida (where vertical integration is mandatory). In that case, it must establish facilities encompassing cultivation, processing, distribution, and retailing of cannabis.

Presently, the prospect of producing in Florida and distributing to New York remains implausible. This stringent requirement effectively nullifies any potential for capitalizing on economies of scale. The typical MSO strategy involves entering nascent markets, reaping early profits and subsequently grappling with escalating competition that erodes margins and imperils sustainability. In some instances, this leads to the unfortunate outcome of shutting down operations.

For speculative minds, this market offers fertile ground. One can engage in forecasting which state is poised to legalize next, predicting the nature of the impending legislation (notably distinct for each state), and identifying companies positioned to establish a presence. Often, the stocks of companies operating within states transitioning from medicinal-only to encompassing recreational use witness notable appreciation.

Illustrating this phenomenon is the case of Goodness Growth, where shares surged by over 150% in May. This remarkable surge was triggered by Minnesota's legalization of cannabis, with sales slated to commence in the first quarter of 2025. This instance encapsulates the market's dynamic interplay between legislative shifts and investment fluctuations.

Source: Bloomberg, L2 Capital

Numerous other instances could be brought to the forefront, yet we don't perceive this pursuit as a mere investment endeavor. Our approach diverges from conventional practices. Rather than seeking transient gains, we set our sights on companies poised to carve out unique niches and flourish even in the face of adversity—regardless of government support.

We acknowledge the pivotal roles that liquidity and scale play within markets. Positive industry-wide developments will likely trigger an initially robust response in MSO shares. However, our focus transcends tactical trading strategies, honing in on the substantial long-term potential that underlies the cannabis landscape.

Contrary to opting for the famous MSOs, which have shown a recent downward trajectory (exemplified by the nearly 30% decline in the MSOS ETF this year), we've followed an alternative path. Our pursuit has led us to unearth companies outside mainstream attention, eluding analyst coverage and (nearly) avoiding inclusion in any ETF. These entities stand out due to their impressive profit margins, exceptional product offerings, and steadfast growth trajectories.

Today, we'll delve into the story of Glass House Brands (hereafter referred to as GH), an exemplar of the previously mentioned category. GH has already achieved a remarkable surge of over 100% in its share value this year—an achievement that we consider merely a prelude to its potential ascent.

Before delving into GH's narrative, it's pertinent to revisit the second recommendation put forth by analysts: to exercise caution regarding California. Although we extensively addressed California in our previous communication last year, it's valuable to touch upon a few key points as a backdrop for this report.

Foremost, it's imperative to highlight California's status as the largest cannabis market within the United States—a distinction that extends to the global stage. This is underscored by its adult population exceeding 31 million individuals and hosting a staggering array of over a thousand cannabis brands.

Beneath the challenges we are about to discuss, a noteworthy fact emerges: experts unanimously acknowledge that cannabis produced in California boasts world-class quality. For the uninitiated, the Emerald Triangle holds a significance akin to the revered Champagne region in France, renowned for its exceptional terroir quality.

California's climate proves to be an ideal canvas for cultivating cannabis. It benefits from ample sunlight, conducive humidity levels, and a wealth of skilled cultivators. To speak candidly, attempting to grow cannabis in a location like New York appears counterintuitive. Factors such as elevated land costs, reduced sunlight, fluctuating temperatures between seasons, and the substantial expenses incurred in tailoring facilities to the plant's specific needs (humidity, temperature, lighting) render it an impractical endeavor.

As a parallel, no one seeks to cultivate bananas or oranges in New York—or any comparable state. Similarly, the logic behind growing cannabis in such regions is questionable. It's only a matter of time before regulatory adjustments address this matter, although we won't delve into that aspect here.

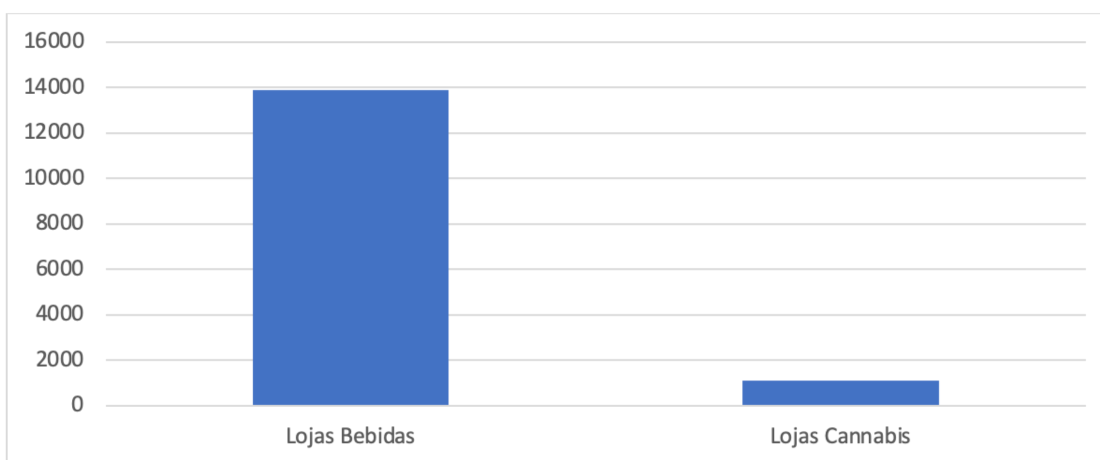
According to the insights gathered from industry experts in our interactions last year, California grappled with a multitude of issues. Overproduction, heightened taxes on cannabis cultivation, intense competition from the illicit market, insufficient enforcement measures, and price wars were among the challenges cited.

Having experienced California firsthand, we can affirm that every assertion made by analysts held true. However, their vantage point fell short in recognizing the impending shift—a transformation that looms on the horizon. As we've iterated multiple times, our focus doesn't solely pertain to immediate developments in the coming days or weeks. Instead, it centers on the evolution that unfolds over the forthcoming years.

Excessive production, stemming from legalization and the construction of cultivation capacity that vastly exceeded market demand, led to a perplexing situation. Remarkably, over half of the cities in California prohibit adult-use cannabis. Therefore, even though cannabis is legalized at the state level, a significant number of cities remain devoid of legal access to cannabis.

The consequence of this oversaturation of supply was a market saturated with products, leading to price pressures. Many producers, unable to establish distinct identities, found themselves in a race to the bottom—engaging in price competition as the sole remaining differentiator. The culmination of these factors set the stage for an impending catastrophe.

Adding to the complexities, California imposed—and continues to enforce—a plethora of constraints on cannabis retail establishments. The availability of such stores barely reaches 10% of the number required for a thriving and sustainable market. An illustrative graph below highlights the considerable disparity between the numbers of liquor stores and cannabis retail outlets. Encouragingly, a trend of new store openings is gradually emerging in the state, indicating a movement toward rectifying this imbalance—albeit with room for improvement.



Furthermore, the landscape has witnessed the imposition of the California Environmental Quality Act (CEQA), a rigorous legislative framework that poses a hurdle for many state-based companies seeking license renewals—especially considering that a number of licenses are temporary in nature. An analysis by Cannabis Benchmarks, a prominent industry publication, reveals a notable decline in the count of cannabis cultivation licenses from the beginning of 2022 to the start of August this year, plummeting from 8,380 to 6,065—a substantial contraction of nearly 30% that continues to exhibit downward momentum.

Recognizing the adverse impact of exorbitant cannabis cultivation taxes, the state government took a noteworthy step in June of the previous year by abolishing the $160 per pound tax. This unforeseen move was a stark departure from analyst predictions, yet it concurred with warnings voiced by smaller producers who had insight into the sector's challenges.

Simultaneously, the California government initiated a trend toward stricter enforcement against the illicit cannabis market, resulting in the closure of numerous illegal outlets, cultivation sites, warehouses, and processing facilities. The confluence of these factors has ushered in a revival in the prices of diverse cannabis strains. Having plummeted to historic lows last year, prices have rebounded, surging to $700 per pound this year. This resurgence is particularly advantageous for companies engaged in efficient cannabis production and processing.

Now, let's delve into Glass House Brands (GH), the focal point of this report. As emphasized earlier, California serves as an optimal locale for cannabis cultivation, boasting near-ideal conditions encompassing temperature, humidity, and sunlight. GH's strategic positioning within California confers a substantial competitive edge, a factor that will be even more pronounced when interstate commerce becomes an operational reality.

Cannabis is a plant, and its agricultural domain is inherently intricate. As articulated by Roberto Campos, a figure we deeply admire, there are three avenues for financial loss: the most delightful involving women, the quickest tied to gambling, and the most assured associated with investments in agriculture. This sentiment underscores why agriculture often garners significant subsidies in some countries in Europe and other nations.

The crux of agricultural viability lies in scale. Amplifying scale enhances the likelihood of profitability, as fixed costs exhibit minimal variance from a medium-sized farm to a larger one. This principle serves as the bedrock upon which the viability of farming as a business is founded.

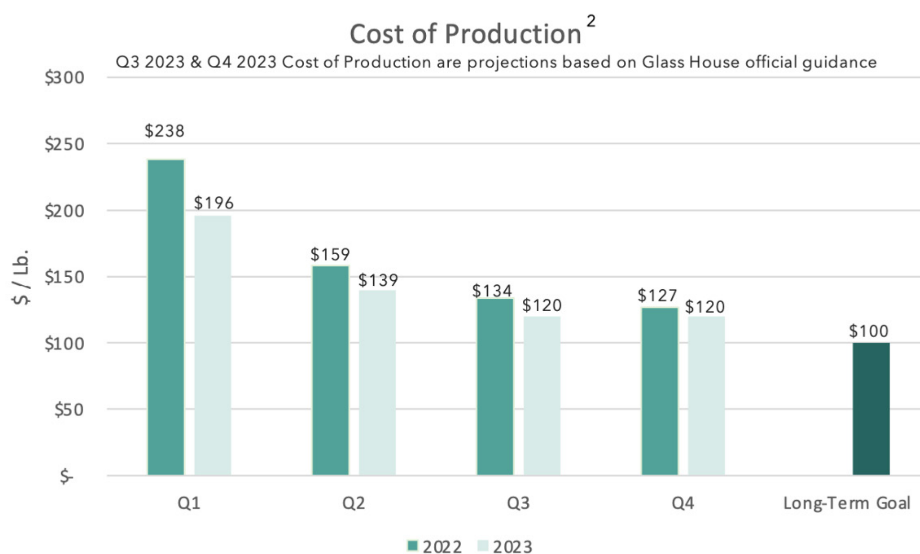
Glass House Brands (GH) stands out as the sole entity within the US to grasp the significance of this agricultural principle, investing significantly in the construction of greenhouses. GH has strategically established six interconnected greenhouses, boasting an impressive total area of approximately 510,000 square meters. Presently, the company is harnessing only a fraction of this capacity, utilizing around 100,000 square meters.

Our visit to these greenhouses last year left us deeply impressed by their scale, quality, and the evident professionalism with which they were operated. For those keen on delving further, an illuminating video documenting this venture is accessible at: [YouTube link: https://www.youtube.com/watch?v=UohXIVnJ28Y

Remarkably, GH is already showcasing its intrinsic value despite tapping into just a mere 27% of its total capacity. During the initial quarter of this year, the cost of producing cannabis amounted to a mere US$196 per pound. This cost exhibited a further reduction in the subsequent quarter, plummeting to an impressive US$139 per pound—a noteworthy accomplishment.

Furthermore, GH harbors aspirations of driving down its production costs to an astounding US$100 per pound in the long run. This vision is entirely conceivable, given that the company currently exploits only a fraction of its greenhouse space. As GH progressively expands its cultivated area, its profit margin should experience a corresponding surge.

Looking forward to the second half of 2023, GH's internal projections forecast production costs to be a mere US$120 per pound. While a degree of skepticism is typically prudent regarding company forecasts, GH has consistently defied expectations by delivering figures that surpass initial projections.



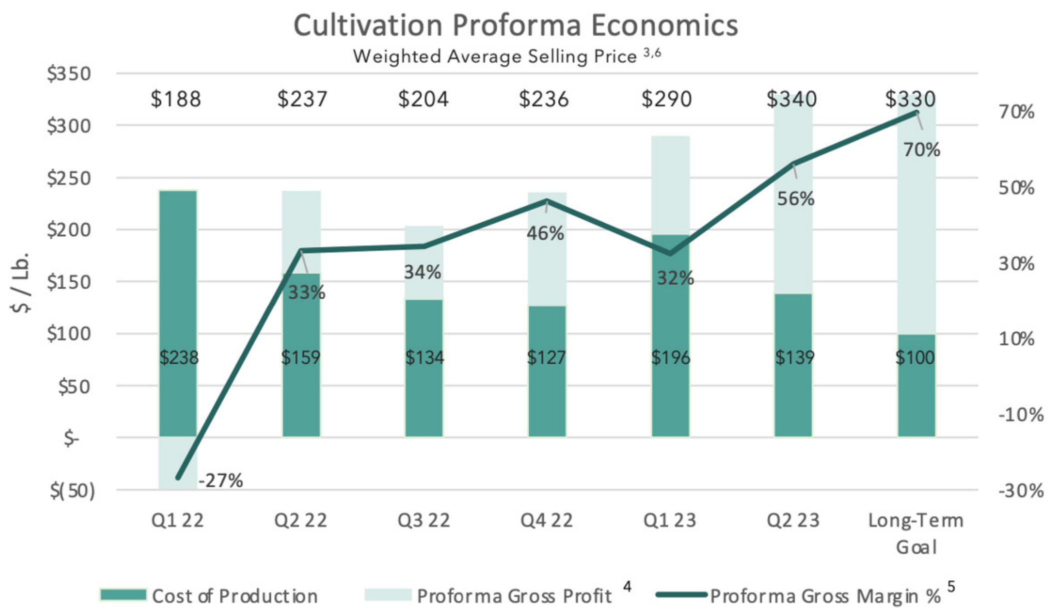
Source: Glass House

Indeed, Glass House Brands (GH) stands on a pedestal of unparalleled competitiveness within the US cannabis landscape. Its monumental competitive advantage, stemming from its visionary investment in expansive greenhouses, is a feat that remains unattainable for rival companies. With licenses for such vast greenhouse spaces already fully allocated, the potential for replication is extinguished.

GH's accomplishment takes center stage when juxtaposed against the production costs of certain MSOs, which can soar beyond US$1,000 per pound—nearly ten times the cost achieved by GH. This stark differential underscores a fundamental principle: controlling the market price of a commodity can be elusive, exerting dominion over production costs is not only attainable but also strategically imperative. This is precisely the avenue that GH is skillfully navigating.

The ramifications of lower production costs are far-reaching. They translate into broader margins, augmented profitability, and growth that eclipses market norms. This competitive edge also cultivates resilience and prosperity within an intricate market landscape characterized by intense rivalry. GH's capability to curate its costs grants it a commanding stance, enhancing its influence over both clients and suppliers. Amid a sector where competitors grapple with negative margins, GH's last quarter's 56% gross margin is an exceptional, virtually unparalleled advantage.

In essence, GH's capacity to outpace rivals regarding cost efficiency doesn't merely signify a competitive edge; it symbolizes the capability to endure and flourish in an environment brimming with challenges and fierce competition. This distinctive position empowers GH to chart an upward trajectory that transcends market norms and propels it toward resounding success.



Source: Glass House

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The risk disparity between MSOs and companies like GH is unmistakable, primarily due to the substantial contrast in production costs. As interstate commerce eventually materializes, the swift erosion of margins among MSOs is a reasonable outcome, possibly leading to negative margins in the face of intense competition.

The prospect of rivaling a company like GH, with its monumental greenhouse space advantage and remarkably low production costs, in a complex and fiercely competitive market like California seems insurmountable. As the curtains rise on interstate commerce, the comparative advantages of GH are poised to shine even brighter.

GH's financial performance is nothing short of remarkable. Amidst an industry landscape where numerous companies are consuming cash at a rapid pace, GH stands out by generating exceptional cash flows. The first quarter saw an impressive $4.5 million, which ballooned to an astonishing $8.3 million in the second quarter. This remarkable pace is anticipated to amplify further as production scales up, costs plummet, and competitive pressures ease, culminating in the attainment of more favorable pricing.

It's crucial to underscore that GH's achievements have materialized despite challenging circumstances. With cannabis sales witnessing a 9% decline compared to the previous year, GH has ascended to leadership within the US's most competitive and fragmented market.

While acknowledging the inherent uncertainty in forecasting, our projections tentatively suggest that GH could achieve a net profit as early as next year, amounting to $20 million—a figure poised to escalate to $80 million by 2025.

	2023	2024	2025	2026	2027
Revenue	161,000	288,000	473,000	522,000	524,000
COGS	79,500	115,000	172,000	186,000	185,000
Gross Profit	81,500	173,000	301,000	336,000	339,000
Gross Profit %	50.62	60.07	63.64	64.37	64.69
Total Expenses	97,400	89,000	114,000	122,000	122,000
Operating Income	(15,900)	84,000	187,000	214,000	217,000
Interest Expense, net	13,000	10,000	10,000	10,000	10,000
Taxes	23,000	53,000	93,000	105,000	105,000
NI	(51,900)	21,000	84,000	99,000	102,000

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The prospects laid out for Glass House Brands (GH) are indeed compelling and underscored by robust financial potential. Even if the timeline for greenhouse development is extended by an additional year, the company—currently valued at less than $250 million on the stock exchange (with initial investments when it was below $100 million)—has the potential to generate $80 million in profits by 2026. This would translate to a remarkably low price-to-earnings (P/E) ratio of 3—an exceptionally favorable valuation metric. Moreover, this profit trajectory is anticipated to ascend further in subsequent years, bolstering the appeal of the investment.

A P/E ratio of 3 for a company projected to maintain double-digit growth in the intricacies of the US cannabis market—amidst competition from illegal trade, challenging regulations, limited sales outlets, and the absence of interstate commerce—represents an opportunity that's difficult to overlook. The company's prospects stand to further amplify if various elements improve, whether it's local legislation, a curb of the black market, a reduction in competitors, or the expansion into new markets. The potential removal of the constraints posed by Section 280E of the IRS Code due to cannabis reclassification would serve as an additional catalyst for projected profits.

Furthermore, the industry's allure has garnered the attention of major players in other sectors, such as big tobacco, big pharma, and big alcohol. Their entry into the cannabis realm could catalyze substantial synergies and potential returns, making mergers and acquisitions a promising avenue for generating additional investor returns.

Notably, GH's absence from ETF inclusion and its recent coverage by only a few analysts this year implies a relative scarcity of competition in terms of share acquisition. While your investment capacity has reached its limit, this report's public release underscores your commitment to sharing valuable insights.

Nonetheless, it's vital to acknowledge the inherent risks associated with the thesis and GH, from litigation and intense competition to legislative shifts and unforeseen accidents. Prudent caution is advised. This report neither constitutes an investment recommendation nor should anyone invest in GH solely based on its content. L2 Capital explicitly disclaims issuing investment recommendations.

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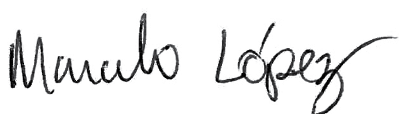

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