HUB 2022 Outlook — Cannabis Industry

Balancing Big Risks and Big Rewards

A maturing cannabis industry has the potential for enormous growth — but only if growers, processors and retailers can minimize threats to their profitability and stability.

With legalization becoming more common, the cannabis industry has been on a roll.

The U.S. cannabis industry hit a record $24 billion in sales in 2021, with expected annual sales of $70 billion by 2028.[1]

Cannabis risks have always outpaced the availability of insurance, in large part because of its status as a federally outlawed substance and the dangers in extraction and production. But it now shares many of the same risks as other industries — catastrophic crop damage, cyber risk and a shortage of skilled workers.

Some relief for the industry's financial issues may be ahead: The SAFE and CLAIM Acts, if passed, carry with them the potential to bring traditional financial resources to cannabis operations.

Insurance for cannabis businesses remains expensive. Cyber coverage is expected to rise 30% or more, as cyber risks explode and more businesses seek coverage. Executive liability policies including Employment Practices Liability (EPL) and Directors & Officers (D&O) premiums are expected to increase 10% to 20%.

Cannabis Property-Casualty coverage is also expected to rise 10% to 20%, except for businesses in catastrophe-prone areas, which will see increases of 20% and up.

These factors of additional risks and higher insurance premiums won't inhibit industry growth, but those cannabis businesses that invest in risk management will be the ones to benefit the most.

[1] CNBC, "Cannabis is projected to be a $70 Billion market by 2028," July 1, 2021.

Here's what to expect in cannabis industry in 2022:

1. Barriers to business growth may result in more M&A

Perhaps the biggest obstacle to cannabis industry growth is a lack of access to capital.

The industry awaits passage of the SAFE and CLAIM Acts, which would allow cannabis businesses to accept loans from federally regulated institutions. Lending to the industry has been restricted because regulators have considered it a form of money laundering; the pending legislation would remove that criminal designation for banking and lending.[2]

Lending institutions have limited lending to non-cannabis operations (i.e., those that don't have to do with the cannabis plant itself).

But for now, large cannabis enterprises with non-cannabis subsidiaries have more access to capital than small companies. Similarly, large cannabis organizations typically have an easier time obtaining private equity investments.

As a result, M&A activity will increase in 2022, as large cannabis businesses will have the means to acquire smaller competitors. What's more, expect Canadian cannabis companies — unburdened by federal restrictions — to increase their cross-border mergers and acquisitions.

[2] The National Law Review, "Cannabis Banking: An Update on the SAFE Banking Act," August 25, 2021.

2. Growers will battle catastrophe risk

Securing crop insurance has always been difficult for cannabis. Add persistent severe weather, and it creates a perfect storm for crop risk.

Policies that transfer wind and hurricane damage risk in Florida or wildfire and smoke taint in California are virtually non-existent for cannabis — and for outdoor growers, a single weather event can wipe out an entire crop with no recourse.

One possible solution: Parametric insurance, which pays out in full when a weather element reaches a threshold, regardless of the actual damage.

Growers with indoor operations, or those considering moving that way, have to cope with energy conservation initiatives. Measures like the one in California that would require indoor growers to use LED lighting by 2023 could cost the industry millions and present a direct threat to small operations' viability.[3]

This makes it important for cannabis producers to institute conservation measures and undertake risk mitigation measures like improved safety measures at indoor growth facilities ahead of 2022 renewals.

[3] MJBiz Daily, "Proposed LED mandate could cost California's indoor marijuana growers millions," July 21, 2020.

3. R&D will be a flammable issue for cannabis

Cannabis extraction can be a dangerous business involving hazardous and explosive chemicals, giving rise to high insurance premiums.

In general, the industry is reducing its use of dangerous chemicals, but the technology isn't there to eliminate the use of solvents like butane, propane, ethanol and carbon dioxide, which represent a health risk for workers and consumers alike.[4]

There are more issues involving THC variants: Delta 8, which is federally legal, and Delta 9, a more potent THC product that is not federally legal,[5] will continue to gain traction into 2022 in states where cannabis remains illegal. Delta 8 and Delta 9 manufacturers claim the low levels of THC in these variants can be deemed legal according to the 2018 Farm Bill.

Lack of testing and oversight means there are no guarantees as to the THC levels of Delta 8 and Delta 9 products; what's more, manufacturers may add bleach to make these products look natural.

With as many as 500 unique cannabis compounds, variants will continue to be an issue until federal legislation requires FDA oversight. The problem for all cannabis businesses is that this lack of oversight equals higher risk and insurance premiums.

To reduce risk and ensure coverage, cannabis extractors and processors should aim for transparency, hiring a third-party testing company to certify their products and giving underwriters insight into their R&D and extraction processes.

[4] Alchimia 20, "Complete guide to solvent cannabis extracts," March 30, 2018.
[5] Discover, "What is the difference between Delta 8 THC and Delta 9 THC?," June 23, 2021.

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4. Cybercrime will be the top manufacturing risk

When Colonial Pipeline and JBS Foods were hit with ransomware attacks in 2021, it raised a major red flag for the cannabis industry.

The manufacturing risks from cybercrime are particularly unnerving. For instance, a bad actor could turn off a carbon dioxide feed to an extraction operation and demand a ransom to restore it.

Or worse, consider the liability if a cyberattack affects product labeling and a 20-milligram edible is advertised as 10-milligram product — the ramifications extend well beyond business interruption or a loss of revenue.

Cybercrime in cannabis extraction also opens up a host of irregular (if not uninsurable) risks. If a hacker cuts off air conditioning in a growth facility and the plants develop mold, would that be covered under a cyber policy, property-casualty policy, or neither?

Cannabis businesses are especially vulnerable to bad actors because of their cash reserves and often weak IT infrastructure. But nearly 60% of cannabis businesses say they haven't taken the necessary steps to prevent a cyberattack.[6]

And if cannabis businesses assume cyber insurance will take care of any issues, they need to realize availability is limited at best, and for those enterprises than can secure cyber insurance, rates will rise 30% and upwards in 2022.

That puts the onus on risk management. Cannabis businesses need to improve network defenses and employee training, and work with an insurance broker to avoid hidden exclusions and ensure coverage for non-traditional cyber exposures.

[6] MJBiz Daily, "Cannabis companies considered ripe targets for ransomware attacks," September 10, 2021. er JBS says it paid equivalent of $11 mln in ransomware attack," June 10, 2021.

Moving forward in 2022

Not only does it have its own risks, but the cannabis industry also faces weather-related disasters, financial obstacles to growth, manufacturing risk and the ever-present threat of cybercrime. This means growth in 2022 will depend upon strong risk management for the industry. Consulting with an insurance brokerage that specializes in their industry will be a wise first step to ensure the risks don't get the better of any cannabis operation.

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