



Innovative Industrial Properties Inc

Ticker: IIPR
Sector: Medical-Use Cannabis
Industry: REIT
Analyst: Robert Zhang

Company Synopsis

Innovative Industrial Properties (IIPR) is the pioneering real estate investment trust for the medical-use cannabis industry. It focus on acquiring specialized industrial real estate assets for the regulated medical-use cannabis industry. The unique sale-leaseback program enables it to offer an attractive alternative to licensed medical-cannabis operators who have limited access to traditional financing alternatives.

Recommendation

| | |
|------------------------|-----------|
| Current Trading Price: | \$ 240.51 |
| (As of 8/27/2021) | |
| Recommendation: | BUY |
| Target Price: | \$ 271.27 |
| Upside/Downside (%) | 12.79% |
| ROIC (%) | 5.79% |

Investment Driver #1

Innovative has the leading position in the medical-cannabis REIT sector with a very strong focus on developing tenant relationships in high-growth markets. Its investments are concentrated in acquiring new properties in these markets and subsequently offering financial support for medical-cannabis cultivators for them to grow their businesses.

Investment Driver #2

The main business drivers behind Innovative's recent popularity lie in its ideal business model and the ever-changing regulations around the medical-cannabis industry. As a cannabis REIT company, Innovative faces growing demand for financial supports as more states legalize the cultivation of medical cannabis, therefore, equipping itself with monopolistic power in terms of pricing.

Company Statistics

| | |
|--------------------|---------------|
| Market Cap | \$5.76 B |
| Enterprise Value | \$4.41 B |
| Shares Outstanding | 23,930 |
| 52 Week High/Low | \$108.5 – 245 |
| Beta (Against RUT) | 0.93 |
| Short Interest | 5.49% |
| Revenue | \$116.9 M |
| EBITDA | \$ 42.78 M |
| Net Income | \$ 29.34 M |

Analyst Opinion: Market/Company Outlook

The catalyst for Innovative's growth is the ever-increasing demand for medical-cannabis, which witnessed unprecedented growth during the pandemic. With the recently proposed bills on cannabis legalization from Congress, there will be more opportunities and new markets for Innovative. In addition, with more medical-cannabis cultivators seeking for financial support, there is an overwhelming amount of demand on the market but Innovative is the only cannabis REIT who can offer the support. Therefore, its unique business focus and its market dominance equipped it with numerous growth potentials.



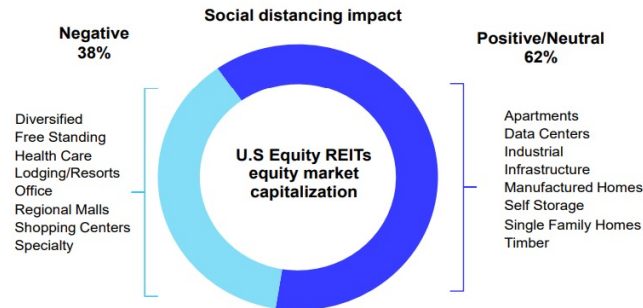
Sources:

INDUSTRY ANALYSIS

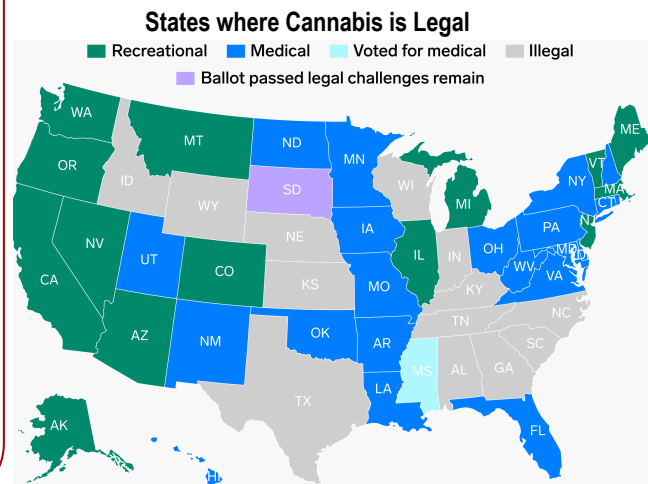
Industry Summary

The REIT sector is positioned for regain in 2021 after the economic and social disruption caused by COVID-19 which resulted in a 5% decline in returns for the All Equity REITs Index last year. REITs have been resilient during the pandemic due to their strengthened financial positions since the last financial crisis. In particular, Industrial REITs with real estate assets are built specifically for certain businesses, making it difficult for them to find replacements in the short-term. Major players include Prologis (NYSE:PLD), Duke Realty (NYSE: DRE), and the subject of this report, Innovative Industrial Properties (NYSE: IIPR), aggregating to roughly \$62.8 billion in market capitalization. With the Fed committed in keeping interest rate low through bond purchases and the bipartisan infrastructure plan, industrial-related REITs that generated a 9.8% total return in 2020 are the likely beneficiaries in the long-term. Among them, cannabis REITs have fared relatively well in this recessionary environment and offered attractive opportunities for state-licensed cannabis operators.

Chart 9: Impact of COVID-19 on REIT Sectors
2/3rds of Equity REITs are less impacted by social distancing



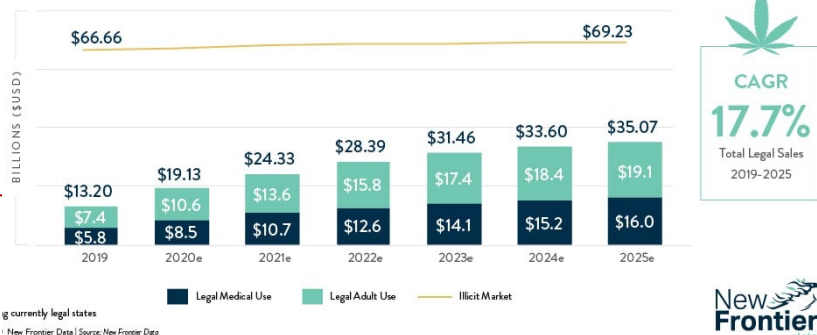
Source: Nareit analysis of equity market capitalization for equity REITs



Industry Trend #1: Rising Number of Tenants

Cannabis has been federally restricted since the 1930s but has continued towards increased legalization. After the 2020 election, medical usage is now legal in 35 states while recreational usage is legal in 15 states. With this increased legalization, cannabis sales across the U.S. have seen a massive increase during the pandemic. According to a recent report from New Frontier Data, the legal U.S. cannabis industry is expected to grow by a CAGR of 17.7% between 2019 and 2025, reaching roughly \$35 billion in sales by 2025.

Existing federal prohibition, and limited access to banking, has forced cultivators to seek alternative sources of capital, including cannabis REITs like Innovative Industrial. Over the last four years, it has expanded its portfolio to include 63 properties spanning 14 states, all of which have legalized cannabis cultivation. IIP has been able to pursue an aggressive acquisition strategy without taking on excessive debt, using equity rather than debt capital to fuel growth.

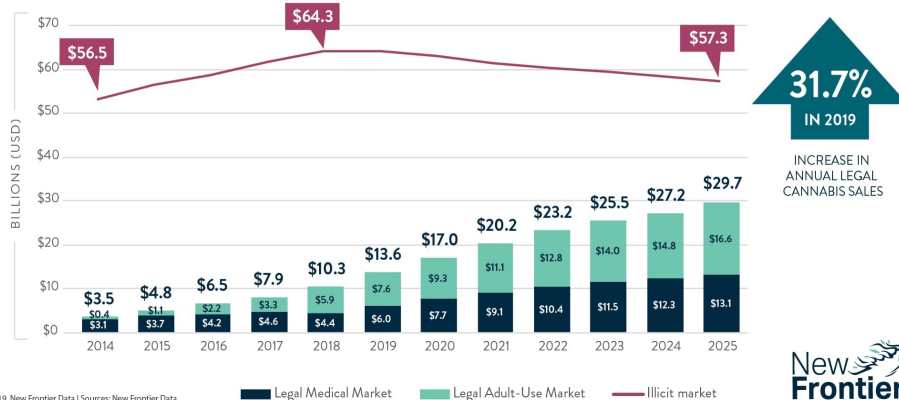


INDUSTRY ANALYSIS

Industry Trend #2: High Financing Needs with Low Supply

The sales of legal cannabis in the U.S. has more than tripled between 2014 and 2018, but this does not mean there will not be a steep learning curve for the industry to contend with. As of currently, cannabis remains a Schedule I substance at the federal level which means it is considered illicit, prone to abuse, and is not recognized as having medical benefits. Although this classification has not prevented 35 states from legalizing medical cannabis, cannabis companies still have limited or no basic access to basic banking services. As a leading provider of real estate financing for state-licensed medical cannabis growers, IIP acquires properties via sale-leaseback transactions with them and then makes real estate-backed loans to enable them to expand their operations.

While tenants in other real estate classes struggled to pay their rent in 2020 due to the pandemic, it didn't have much effect on the medical-use cannabis industry. Therefore, IIP collected nearly all the rent it billed.

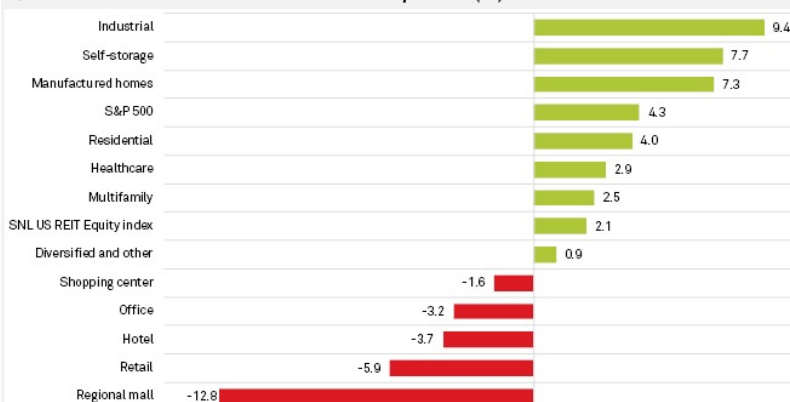


New
Frontier

Industry Weighting and Outlook

In the current growth state of the U.S. economy, REIT prices tend to rise along with interest rates. With an increasing demand for financing needs in the medical-cannabis industry, the value of IIP's underlying assets will be increasing as well. Based on the possibility of two interest rate increases by the end of 2023 according to Fed policymakers, IIP is likely to benefit from that as it has little debt on its balance sheet with reliable tenants paying their rents.

Q2'19 US REIT sector index total return comparison (%)



Data compiled July 1, 2019.
Data as of June 28, 2019.
Source: S&P Global Market Intelligence

Company Involvement

- ☐ Continuous property acquisition throughout 2020 allowed IIP to establish new tenant relationships
- ☐ Partnerships with tenants in the ground-up redevelopment of existing industrial sites in economically challenged areas resulted in 5,000 people employed in 2020
- ☐ Focused on well-capitalized companies that have gone through rigorous state licensing processes

COMPANY SUMMARY

Business Overview

Founded in December 2016, Innovative Industrial Properties (NYSE: IIPR) focused on the acquisition and management of industrial properties leased to **state-licensed operators** for their regulated **cannabis facilities**, with its corporate office located in Park City, Utah. As of December 31, 2020, IIP has owned 66 properties with a weighted-average lease term (WALT) of 16.6 years. It leases its properties to tenants on a **triple-net lease basis**, where they are responsible for all aspects of their operations, including repairs, maintenance, real estate taxes and insurance. It operates in 16 of the 35 states that have legalized cannabis for medical use, with 60% of its property portfolio distributed across Illinois, Pennsylvania, Massachusetts, and Michigan.

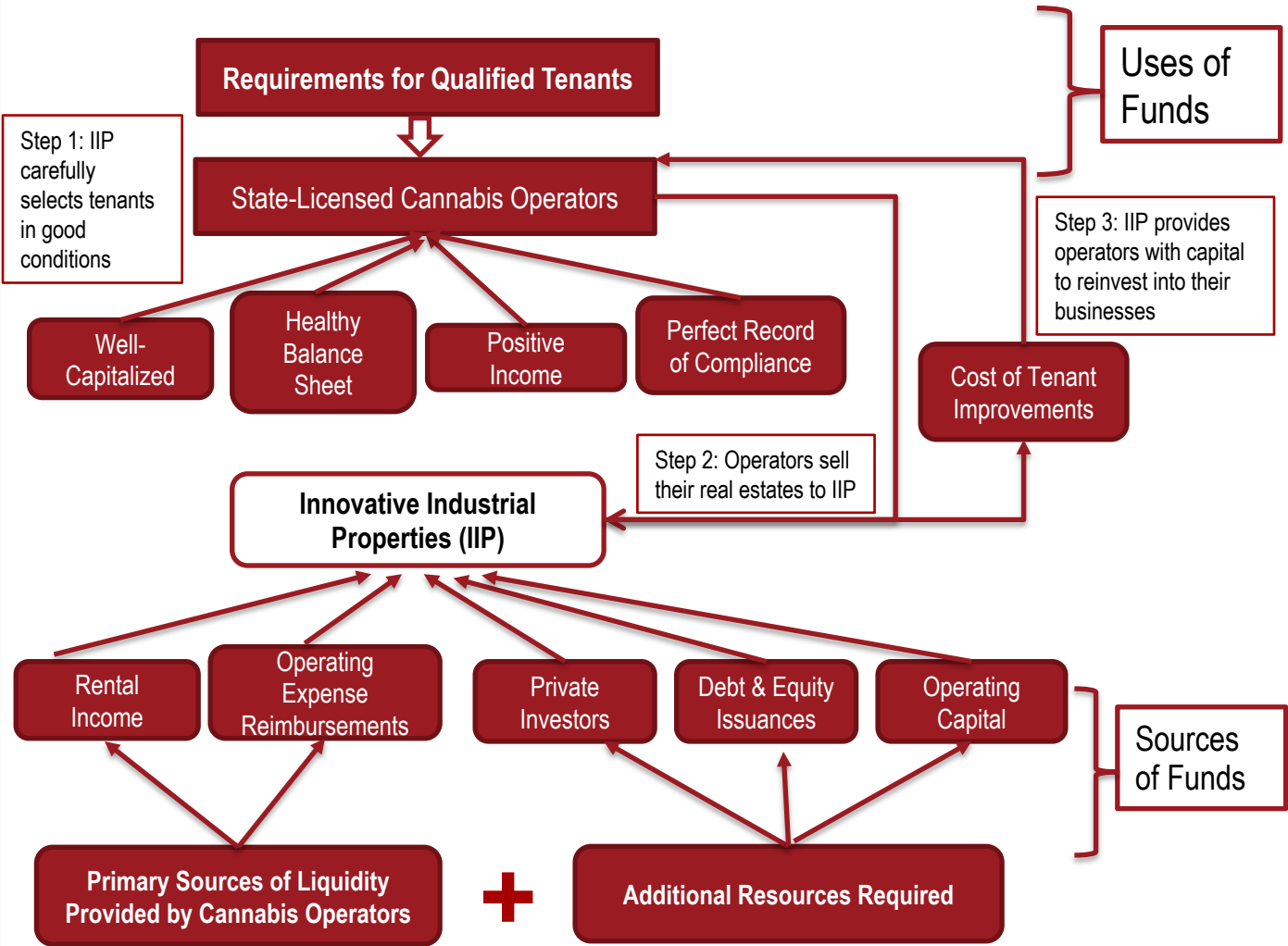
Revenue Generation

Innovative Industrial Properties primarily acquires properties via sale-leaseback transactions with the state-licensed operators and immediately makes real estate-backed loans to enable them to expand their operations. From 2019 to 2020, IIP generated \$79.8 million of revenue with a 196% increase compared to the prior-year period. It also generated \$92.4 million, or \$4.7 per share, of FFO, up a 63.2% compared to the year-ago period. It derives its revenues 100% from the leasing of properties, collecting rental income and reimbursements based on arrangements with tenants.

| | Years Ended December 31, | | |
|--|--------------------------|-----------|----------|
| | 2020 | 2019 | 2018 |
| Net income attributable to common stockholders | \$ 64,378 | \$ 22,123 | \$ 5,633 |
| Real estate depreciation | 28,025 | 8,599 | 2,629 |
| FFO attributable to common stockholders | \$ 92,403 | \$ 30,722 | \$ 8,262 |
| Stock-based compensation | 3,330 | 2,495 | 1,465 |
| Non-cash interest expense | 2,040 | 1,678 | — |
| AFFO attributable to common stockholders | \$ 97,773 | \$ 34,895 | \$ 9,727 |
| FFO per share – basic | \$ 4.75 | \$ 2.91 | \$ 1.16 |
| FFO per share – diluted | \$ 4.72 | \$ 2.88 | \$ 1.13 |
| AFFO per share – basic | \$ 5.03 | \$ 3.31 | \$ 1.36 |
| AFFO per share – diluted | \$ 5.00 | \$ 3.27 | \$ 1.34 |



Revenue Generation Model (Cont'd)

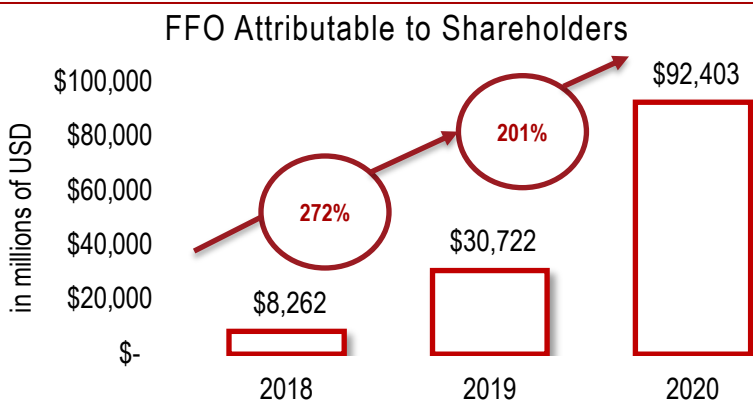


COMPETITIVE ADVANTAGE

Powerful Market Presence: As the industry leader in cannabis REIT, IIP has an impressive **99%** of market share in the niche cannabis REIT sector, while the remaining 1% is captured by **Power REIT**. What makes IIP unique in its sector is that it was able to procure its REIT status before President Trump won the White House. After Trump won, the company's rivals encountered numerous difficulties securing the REIT treatment, essentially extending a competitive advantage to IIP.

Stable yet Lucrative Business Model: IIP's model is simple: buying properties from state-licensed growers and leasing those properties back to them. By selling to IIP, they get **immediate financing** without the hassle of being turned down by local banks. The benefit to IIP is that the leases its tenants sign are usually long term with a WALT around **16.6 years**, providing the company and its investors with cashflow predictability and low earnings variability. Since medical-use cannabis industry benefited from the pandemic, IIP has collected nearly all the rent it billed to its tenants, further sustaining its competitive advantage in its strategy.

Fit Across Value Chain: As of the end of 2020, IIP has acquired 66 properties that were **99.3%** leased on **triple-net leasing** arrangements to licensed cannabis operators with high concentration in top-selling cannabis states like Illinois, Pennsylvania, Massachusetts, and Michigan (accounting for **60%** of its portfolio). These acquired properties provide great expansion opportunities as more state-licensed cannabis growers come to IIP for financing assistance. The **top five state-licensed operators** contribute almost **50%** of IIP's net operating income, presenting stable cashflows based on their experienced operating history.

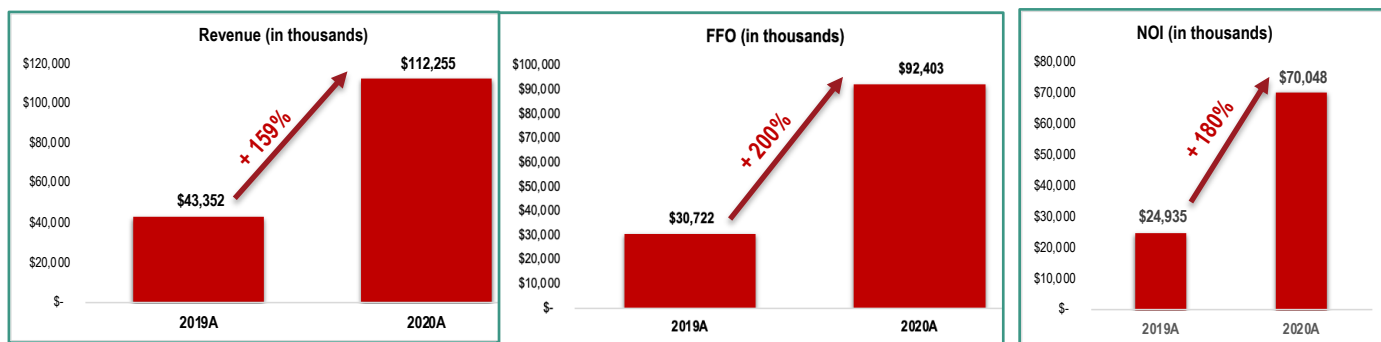


| Innovative Industrial Tenant Roster | | | | | |
|-------------------------------------|--------------------|------------|-------------------|------------|-------------------------|
| Tenant | States | Properties | Total Square Feet | % of Total | Type |
| Parallel | FL | 2 | 593,000 | 11% | Industrial & Greenhouse |
| Ascend Wellness | IL, MI, MA | 3 | 509,000 | 10% | Industrial |
| Green Thumb | PA, OH, IL | 3 | 480,000 | 9% | Industrial |
| Cresco Labs | IL, OH, NJ, MA, MI | 5 | 373,000 | 7% | Industrial & Greenhouse |
| Kings Garden | CA | 6 | 364,000 | 7% | Industrial |

FINANCIAL STATEMENT ANALYSIS

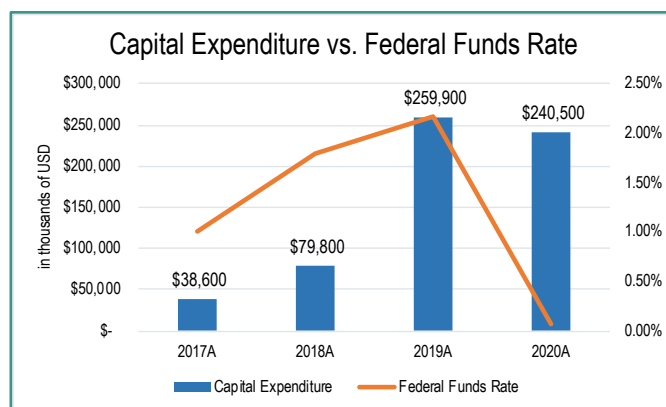
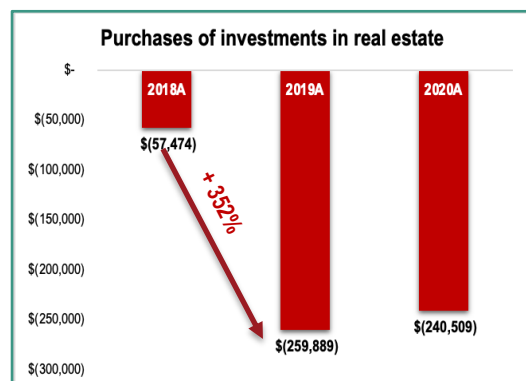
Profitability

In 2020, IIP's **rental revenue** increased by approximately **159%**, with roughly 23% of the revenue contributed by the newly acquired properties. Between January, 2020, and February, 2021, the company acquired **22 medical cannabis properties** while made additional gains by funding existing constructions for tenants and adjusting rents. To keep its competitive positioning in the cannabis REIT sector, it has managed to lease **100%** of its property portfolio in January 2021 with a strategic focus in California. As a reliable measure of REIT profitability, **FFO** grew by **200%** from 2019 to 2020, while **FFO per share** grew by 52%. **Net operating income** increased 180% in the same period, demonstrating the rising value of IIP's 55 acquired properties during 2019 and 2020. In addition, the rental revenue growth rate far exceeds that of total expense by almost **93%** in 2019 and **20%** in 2020, resulting in solid bottom-line improvement.



Spending Initiatives

Operating in the real estate sector means REITs need to bear the burden of **high capital intensity**, but IIPR has a healthy amounts of cash to keep growing its business. As an early entrant into the cannabis industry, it has already established a strong market presence with high returns on its **55 newly acquired properties** in 2019 and 2020 with all of them leased to state-licensed operators at a weighted-average lease term (WALT) of **16.6 years**. Purchase of new properties represents the highest use of cash, resulting in **\$1 billion** in 2020, combined with additional construction funding. Recent investments are focused on increasing its footprint in **high-growth cannabis markets**, with **\$15 million** invested in Pennsylvania and another **\$28 million** in Massachusetts. All of these acquisitions are targeted at forming strong partnerships with some of the **largest multi-state cannabis operators** in the U.S.

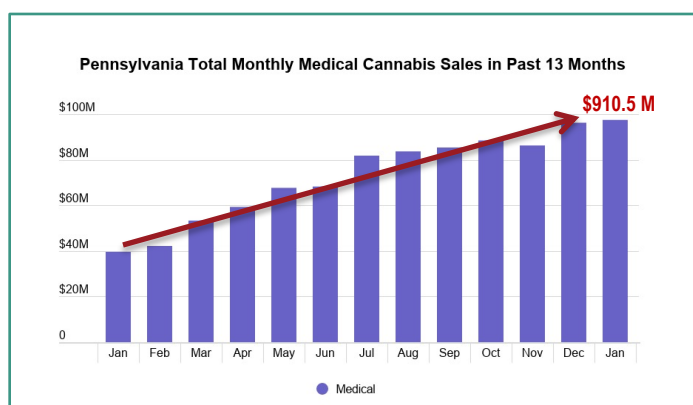


INVESTMENT DRIVERS

Company Trend #1

Investment Focus #1: Establishing strong relationships with multi-state cannabis operators

As cannabis is still illegal at the federal level, many financial institutions refuse to work with medicinal marijuana companies. To fully capitalize on this opportunity, IIP has been consistently acquiring new properties in **high-growth cannabis markets** like **Pennsylvania** and **Massachusetts** to establish **triple-net lease agreements** with the largest multi-state cannabis operators like **Parallel** and **Cresco Labs**. With an aggregate property size of approximately 1.1 million square feet in Pennsylvania, IIP has created a strong foothold in the \$910 million medical cannabis market. Its mid-July expansion into other high-growth markets in **New Jersey** and **Massachusetts** will continue to enhance its competitive positioning in the cannabis REIT market.



April 2

Acquired Mass. property and expanded partnership with Ascend Wellness Holdings

April 22

Acquired Michigan property and expanded relationship with Cresco Labs

May 12

Acquired California property and formed long-term lease with Kings Garden

May 14

Entered into triple-net master lease agreement with Parallel in Pennsylvania

Company Trend #2

Investment Focus #2: Supporting ESG Initiatives

Many of IIP's facilities are located in **economically-challenged locations** with poor infrastructure. A large part of the capital expenditure (approximately **\$4.6 M** annually) has been devoted to carry out ground-up construction and extensive **redevelopment of existing industrial properties**, thereby increased tenants' employment to **5,000** people by the end of 2020.

- ❑ **Lighting upgrades:** Encouraging tenants to upgrade their lighting systems to **LED-based** technologies that use less energy and reduces the need for cooling the buildings.
- ❑ **Greenhouse Construction:** Approximately **\$19.8M** invested in 2020 to renovate greenhouses across five properties, resulting in **reduced lightening** and **HVAC needs**.
- ❑ **Stormwater Management:** Approximately **\$1.4M** in stormwater management systems invested to **reduce water runoff** and **improve water quality** in the surrounding environment.

ASSUMPTIONS AND RISK

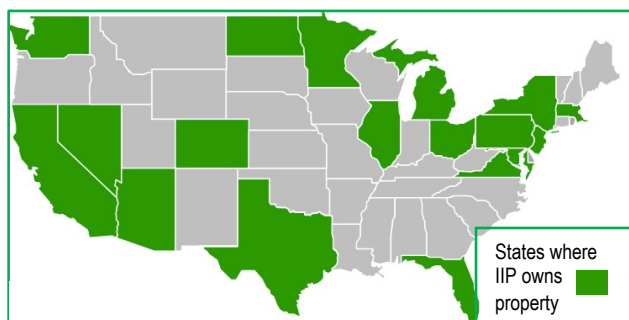
Assumptions

Assumptions: As the pioneering REIT for the medical cannabis industry, IIP has forged numerous **partnerships with vertically integrated cannabis operators** to expand its presence in high-growth states with high demands. By focusing on profitable markets, IIP will continue to attract licensed operators. This long-term growth assumes that **more states will be legalizing use of medical cannabis**, and Chuck Schumer's recent announcement of releasing a bill legalizing marijuana at a Federal level well attest to this underlying assumption.

Investment Driver Risk #1

IIP is the **first and only real estate company** focused on the regulated U.S. **medical cannabis industry**, which means that it has some **monopolistic power** in terms of offering financial support to licensed growers. Should the medical cannabis cultivation and use become legalized in more states, IIP would face potential competitors like **commercial banks** or other **financial institutions** that offer **favourable loan options** for cannabis cultivators. These competitions would certainly **grab market shares away** from IIP and **decrease its occupancy rate**.

\$1.5B Invested Capital
69 Properties Across 18 States
100% Leased



Investment Driver Risk #2

IIP tends to sign **long-term leases, with an average lease length of around 15 years**, that include annual rent increases of roughly 3% to 4%. While this is certainly a solid business model with little default risk, IIP's bull story is at odds with the needs of their tenants. Some of IIP's largest tenant like **Green Thumb Industries** are holding off on any future sale-leaseback financing and **eagerly awaiting to access commercial banks**. With the **3% annual rent escalators**, the cost of capital for IIP's tenants increases each year (**>20% in 2035**) and will likely make its tenants less profitable in the increasingly competitive market of medical cannabis, thus increasing the likelihood of **default risks**.

Hedging Against Risk

To hedge against **tenant default risk**, IIP has a **rigorous credit evaluation system on an on-going bases** for new tenants to ensure they have strong balance sheet to support their long-term operations. With its strong market presence in demand-driven states, IIP can quickly substitutes its failing tenants with new ones who are looking to set up a foothold in the competitive industry of medical cannabis. The beauty of **IIP's sale-leaseback structure** is that it does not need to wait around for an extended bankruptcy to take control of the assets, since the turnaround can be fairly quickly.

EXECUTIVE MANAGEMENT GOALS

Key Management Overview



Paul Smither has been the **CEO** and Director since 2016, with previous experience in managing companies in aerospace, consumer goods, and commercial real estate.



Alan Gold has been the **executive chairman** since IIP's formation in 2016, with previous experience in leading 10+ life science-related REITs.



Tracie Hager is the **VP of asset management** who oversees teams and properties across the US and in the UK, with 30+ years of experience in property management.

Management Vision

- **Focus on investments in acquiring new properties**
 - **73 properties in 18 states** totalling 6.8 million square feet with 100% long-term lease
 - Executed on **over \$245 million** in new transactions since the beginning of the second quarter
- **Commitment in addressing the top ESG priorities**
 - Invests extensively in economically disadvantaged communities, with direct employment of **over 5,000 full time positions**
 - Focus on the redevelopment of existing industrial buildings to reduce demolition and landfill
- **Expand partnership with multi-state cannabis operators**
 - Partnered with **4Front** in ground-up development project in Illinois to meet robust market demand
 - Triple-net lease agreement with **Temescal Wellness** of Massachusetts

Portfolio Update and Investment Activity

| State | Closing Date | Rentable Sq. Ft. ⁽¹⁾ | Purchase Price ⁽²⁾ | Additional Investment | Total Investment |
|---------------|----------------|---------------------------------|-------------------------------|-----------------------|------------------|
| Pennsylvania | April 1, 2021 | 40,000 | N/A | 30,000 | 30,000 |
| Michigan | April 16, 2021 | 175,000 | 15,550 | 14,450 | 30,000 |
| Pennsylvania | May 13, 2021 | 239,000 | 41,750 | 26,000 | 67,750 |
| Michigan | May 14, 2021 | 85,000 | 10,250 | 5,750 | 16,000 |
| Massachusetts | May 26, 2021 | 70,000 | 3,100 | 15,000 | 18,100 |
| Florida | June 8, 2021 | N/A | N/A | 8,000 | 8,000 |
| Florida | June 18, 2021 | N/A | N/A | 7,100 | 7,100 |
| Illinois | August 3, 2021 | 250,000 | 6,500 | 43,750 | 50,250 |
| Totals | | 859,000 | \$ 77,150 | \$ 150,050 | \$ 227,200 |

Discussion and Analysis

I believe IIP's investment activities mentioned above have generated positive outcomes for shareholders. Based on its second quarter 2021 results, total revenues amounted to \$48.9 million in the quarter, representing a 101% increase from the previous year's second quarter. In the meantime, Q2 Y-O-Y growth reached 124% in net income and 104% in AFFO. In addition, IIP obtained an investment grade rating and paid a quarterly dividend of \$1.40 per share to shareholders, representing an 32% increase over the second quarter 2020's dividend.

EQUITY OWNERSHIP AND POSITIONS

Management Ownership & Insider Trading

How many shares does management own?

- IIP’s management holds approximately 2.06% of outstanding common shares, with 1.62% held by CEO

Institutional Investors and Hedge Funds

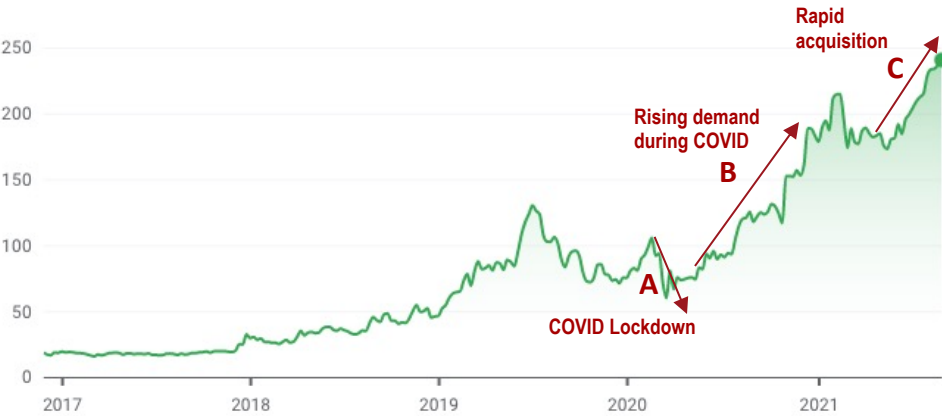
- Both BlackRock and Vanguard hold about 16% of outstanding shares, making them the largest institutional shareholders of IIP
- Three out of the four largest institutional shareholders increased their positions at roughly 26% over the past four months
- Recent increase in holdings proves that IIP’s strategic acquisitions in high-growth market would strengthen its profitability and revenues

Short interest: 5.49% of float

| Holding Summary | |
|-------------------------|------------|
| Institutional Holdings | 75.20% |
| Total number of holders | 443 |
| Total shares held | 17,994,598 |
| Total value of holdings | \$4,328 MM |

| Rank | Holder Name | % Out | Position (in thousands) | Latest Chg (in thousands) |
|------|------------------------------|--------|-------------------------|---------------------------|
| 1 | Vanguard | 15.95% | 3817 | 431 |
| 2 | BlackRock | 15.91% | 3806 | 0 |
| 3 | State Street | 0.50% | 1198 | 38 |
| 4 | Northern Trust | 0.10% | 386 | 15 |
| 5 | Bank of New York Mellon Corp | 0.10% | 275 | -0.89 |

STOCK MOVEMENTS



Events

- A: The initial lockdown during the first few months negatively impacted IIP’s performance, as its tenants faced difficulties in keeping up productions to meet rising demand, which weakened their ability to pay their rents.
- B: Cannabis companies fared well during the pandemic thanks to a surge in demand, which effectively increased IIP’s tenants profitability and the rental income they provided.

C: Acquisitions are the main revenue-driving factor for IIP and it has a strong balance sheet to fuel its growth strategies, which can be seen in its \$227 million investment activities by April 1, 2021.

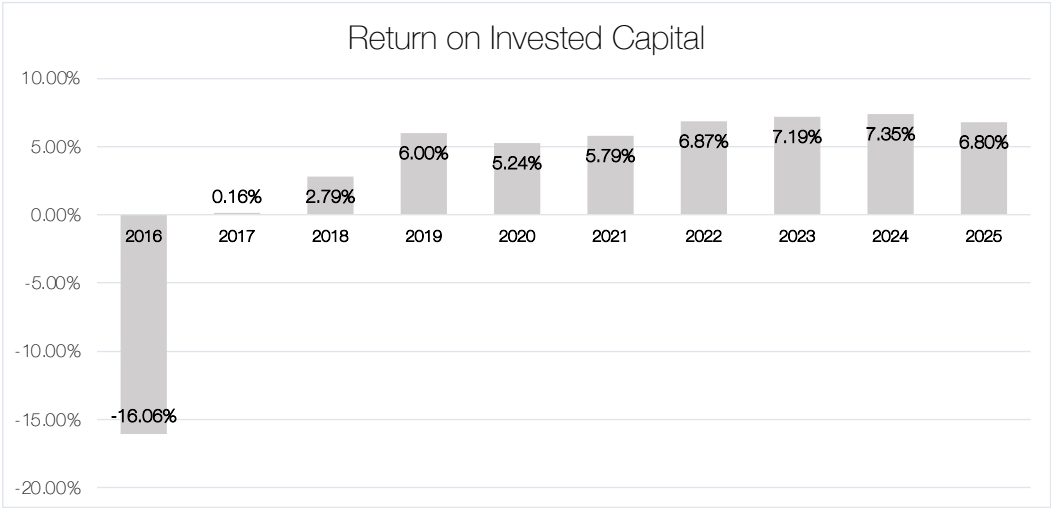


Sources: Motley Fool, Yahoo Finance, IIPR Investor Relations, Bloomberg Terminal

VALUATION SUMMARY & RANGE ANALYSIS

| Methodology | Price / Share | Weight |
|----------------------|---------------|--------|
| Discounted Cash Flow | \$393.26 | 40% |
| Comparable Companies | \$ 217.47 | 30% |
| Net Asset Value | \$ 162.42 | 30% |
| Investment Return | | |
| ROIC (%) | 5.79% | |

| DCF, Comps, NAV Weighting | | |
|--------------------------------|----|--------|
| Implied Share Price from DCF | \$ | 393.26 |
| Implied Share Price from NAV | \$ | 162.42 |
| Implied Share Price from Comps | \$ | 217.47 |
| DCF Weighting | | 40% |
| NAV Weighting | | 30% |
| Comps Weighting | | 30% |
| Implied Share Price | \$ | 271.27 |
| Implied Upside/(Downside) | | 12.79% |



Key Takeaways

DCF methodology yield the largest implied share price compared to the other two methods because the terminal value represents the largest variable. However, IIP faces great growth potentials in the future with more relaxed regulations around medical-cannabis and that will increase its terminal growth rate. Both comparable company analysis and net asset value cannot fully represent the underlying catalysts for IIP, and the disparate business models other comparable companies have cannot attest to IIP’s future growth. Therefore, I allocated 40% to DCF and 30% for both comps analysis and NAV analysis.

Q&A



Innovative Industrial
Properties Inc