**OVERVIEW OF CANNABIS INDUSTRY**

**Market Opportunity:**

The legal cannabis markets in the United States are expanding rapidly. There are now twenty-four states, including Washington D.C., with medical cannabis programs and four of these states (Alaska, Colorado, Oregon and Washington), plus Washington D.C. have also legalized cannabis for recreational use.

The General Partner believes the market will continue to rapidly expand as existing states broaden the definition of the approved uses for cannabis (i.e. from medicinal to recreational use) and new states come online. Despite the fact that the Federal Controlled Substances Act makes the use and possession of marijuana illegal on a national level, recent guidance from the federal government suggests that it will continue to tolerate legalization at the state level, especially when backed by strong and effective regulation. It is significant to note that in 2015, the Congressional Spending Bill specifically prevents the Justice Department from spending money to enforce the federal ban on growing or selling cannabis in states where cannabis has been approved.

Not since the repeal of Prohibition in 1933, has a consumer product business opportunity of this magnitude been created simply by changes in the law. According to an IBISWorld report, the cannabis industry is expected to achieve rapid growth over the next five years. The industry will continue to benefit from increasingly favorable attitudes towards medical cannabis-based treatments and applications as industry’s product acceptance and legitimacy continues to grow, building on a trend that has formed over the previous five years.

**Medical Cannabis Market**:

The last five years have seen a dramatic shift in public opinion on medical marijuana and this is reflected in the direction of individual states toward legalization. A Harris Poll survey from May 2015 showed that 81% of Americans are now in favor of legalizing medical cannabis. Twenty-four states including Washington D.C., have enacted medical cannabis laws, and there are approximately 1.2 million registered patients within these states. The five states with the largest known current medical marijuana patient populations are: California, Colorado, Michigan, Oregon and Washington.

Cannabis has been used for medicinal purposes for thousands of years and has proven to be an effective treatment for pain relief, inflammation and a number of other medical disorders. According to an IBISWorld report, new medical research and changing public opinion have boosted industry growth. Doctors may prescribe ‘legalized’ medical cannabis in approved states where patients can receive a ‘recommendation’ from a state-approved, licensed physician for the treatment of certain conditions specified by the state. Medical cannabis is being used to treat severe or chronic pain, inflammation, nausea and vomiting,

neurologic symptoms (including muscle spasticity), glaucoma, cancer, multiple sclerosis, post-traumatic stress disorder (“PTSD”), anorexia, arthritis, Alzheimer’s, Crohn’s disease, fibromyalgia, ADD, ADHD, Tourette’s syndrome, spinal cord injury and numerous other conditions. Cannabis oil has also been proven effective in treating epileptic seizures in children.

**Recreational Cannabis Market:**

Four states have legalized recreational cannabis – Alaska, Colorado, Oregon, Washington, plus Washington DC. In November 2012, Colorado voters legalized recreational marijuana use. This history-changing legislation has created a window of opportunity for the commercialization and state taxation of a plant group that has, until now, been virtually untouchable and has set the wheels in motion for other states to follow. In July of 2014, Washington State launched its recreational program and in November 2014, Oregon and Alaska and the District of Columbia voted to introduce recreational programs commencing in 2015. A Gallup Poll survey from October 2015 showed that 58% of Americans are now in favor of legalizing cannabis.

**Current Developments:**

2016 is poised to be a banner election year with the possibility of multiple jurisdictions enacting legalizing measures. Most analysts estimate that the 12 states most likely to enact adult recreational marijuana laws in the next 2-3 years are: Arizona, California, Delaware, Hawaii, Maine, Maryland, Massachusetts, Missouri, New Hampshire, Nevada, Rhode Island, Vermont. According to an October 2015 Gallup Poll 58% of Americans favor the legalizing of cannabis.

**The U.S. Cannabis Market:**

In a Bank of America / Merrill Lynch cannabis industry research report from December 2015, estimates of the total market size for cannabis sales in the U.S. ranges from $33 billion to $100 billion. That said, according to the report total legal (medical and recreational) cannabis sales could reach $35 billion by 2020.

Another recent cannabis industry research report from Ackrell Capital forecasts the potential growth of theoverall legal cannabis consumer market size to $100 billion by 2029 with over 50 million estimated users.

According to an industry research and investment forum, the ArcView Group, legal U.S. cannabis sales increased to $5.4 billion for 2015 from $4.6 billion in 2014 and includes medical and adult consumer sales. This annual gain was largely fueled by the growth in consumer sales, as additional states have approved adult recreational cannabis use. According to ArcView estimates, in 2013 the legal U.S. cannabis market was only a $1.4 billion industry and is targeted to grow to approximately $10 billion in legal sales by 2018 as the country’s view on legalizing cannabis has shifted overwhelmingly positive in the last few years.

According to the government sponsored National Survey on Drug Use and Health (“NSDUH”), there were 19.8 million ‘current’ marijuana users in the U.S. in 2013 (used within the past month), up from 14.5 million in 2007.

These self-reported results may be conservative based on the reluctance of respondents to admit to the use of an illegal substance in a government-sponsored survey. For example, an international review found general population surveys underestimate alcohol consumption, sometimes by more than 50 percent. These studies suggest that it may be appropriate to inflate the NSDUH-only consumption estimates by a factor of two. Consider that the average marijuana user may spend approximately $1,800 per year on cannabis, according to some estimates (approximately the same estimated amount spent annually by a pack-a-day cigarette smoker). Hence, the low and high industry sales estimate using the NSDUH data range from $36 billion to $72 billion.

By comparison, the U.S. beer market sales last year were estimated at $102 billion, the U.S. cigarette market at $66 billion and the US coffee market at $30 billion.

It is estimated that for every $1 of legally sold marijuana an additional $2.60 of economic value enters the American economy through ancillary businesses. The cannabis market differs from other emerging markets in that businesses typically expend considerable resources to stimulate demand, while in the cannabis industry significant demand already exists. The demand continues to outpace legal supply due to limitations in state regulations, federal drug, tax and banking laws, and lack of interstate trade.

As more states embrace legalization in some form and existing state programs mature, the demand for cannabis related real estate continues to increase.

**Cannabis Worldwide Market:**

According to the United Nations Office on Drugs and Crime – World Drug Report 2012, there were approximately 33 million cannabis users in North America and as many as 225 million worldwide in 2010, which could drive worldwide sales into the $100’s of billions in terms of market size potential.

**Regulatory Environment:**

The regulatory status of the cannabis industry is shifting rapidly at the state level, with momentum toward a change at the federal level through pressure on the U.S. Congress and the White House. Current federal regulations classify cannabis as a Schedule 1 substance, defined as “drugs with no currently accepted medical use and a high potential for abuse.” This drug classification also includes heroin, LSD and ecstasy.

The legal cannabis industry has evolved considerably over the past 3-5 years. The industry has now reached the tipping point for legalization through pressure from citizens’ groups in individual states for the legalization of medical and/or recreational marijuana. As reported by Pew Research Center in April 2015, nearly half (49%) of Americans say they have tried marijuana, and 12% have tried it within the past year.

In a national poll in October 2014 by Third Way, a public policy think tank, 78% of respondents favored allowing individuals to use marijuana for medical purposes if ‘recommended’ by a doctor. This trend is further illustrated in a recent surveys of public opinion for marijuana legalization rapidly outpacing opposition. A majority of Americans now favor broad legalization of marijuana. Opinions have changed drastically since 1969, when Gallup first asked the question and found that just 12% favored legalizing marijuana use compared to 58% in 2015.

Millennials (currently 18-34) have been in the forefront of this change: 68% favor legalizing marijuana use, by far the highest percentage of any age cohort. But across all generations - except for the Silent Generation (ages 70-87) – support for legalization has risen sharply over the past decade. Third Way also found that 67% of respondents favor Congress passing a bill giving states that have legalized marijuana a safe haven from federal marijuana laws, so long as they have a strong regulatory system, and when given an option of state or federal control, 60% favor states’ control in deciding whether to legalize marijuana.

Public support has given rise to the passage of new marijuana laws and regulations in a number of states, as well as multiple legal reforms on legislative dockets. Each state’s legal environment is unique, making it critical for businesses to know and understand the regulatory landscape on a state-by-state basis.

Another regulatory variable adding to the complexity of the legal cannabis market are the local laws at the municipality and county levels. Even when a state enacts legislation legalizing cannabis, each level of local government has the right to exercise restrictions on cannabis activities, such as retail, consumption, transportation and cultivation. Zoning is an area of particular concern, which is set forth at the local level. This can 25 First Harvest Real Estate Fund 1, LP Private Placement Memorandum Dated March 26, 2016 restrict businesses on where they can be located and the manner and size in which they operate. Understanding individual state’s laws and local regulations requires business operators and investors to account for multiple levels of regulatory compliance, such as how marijuana may be sourced, processed, distributed, and to whom, where and how it may be sold.

**States Legal Status:**

While new state-level legalization efforts continue to expand the number of states involved in the cannabis industry, only a handful of existing states have any meaningful full-scale operations for the cultivation and distribution of cannabis. This presents a significant growth opportunity for investment over the next several years as the existing legalized states and new states’ markets come online.

• Medical Marijuana Legalization - 24 states have legalized medical marijuana, including Washington D.C.

• Medical Marijuana Legalization (CBD Oil Only) - 16 states have CBD-specific, limited medical marijuana laws (not considered full medical marijuana legalization; CBD oils are the non-psychoactive property)

• Marijuana Legalization - 4 states (AK, CO, OR, WA, plus Washington D.C.) have passed laws that allow for adult recreational use of marijuana

• Marijuana Decriminalization - 15 states have decriminalized recreational marijuana use

• Hemp Legalization - 24 states allow for the legal cultivation of hemp

**Federal Legal Status:**

Cannabis is still classified as an illegal substance in the U.S. The Drug Enforcement Agency (“DEA”) and the Food and Drug Administration (“FDA”) currently classify cannabis as a Schedule 1 drug under the Controlled Substances Act. The classification makes cannabis illegal under federal law to cultivate, manufacture, distribute or possess cannabis, and has created a discrepancy between state’s rights and federal law.

This discrepancy has created a complicated environment for cannabis businesses in regards to restrictive banking regulations, interstate trade, IRS tax code and federal bankruptcy laws, especially for companies that directly ‘touch the plant’ such as growers and distributors. For example, since the possession or distribution of cannabis violates federal law, banks that provide services may face the threat of prosecution or sanctions. As a result of being denied banking services or direct access to conventional loans, many of the companies that grow or distribute cannabis directly are forced to transact business on a cash-only basis.

The banking issues created by the federal laws have required the cannabis industry to focus on viable alternatives and have created opportunities for new providers, from finance companies to security and software firms. The issue of interstate trade requires companies that grow or distribute cannabis to duplicate efforts within each state they wish to legally operate and has limited the development of ‘national’ brands. These laws do not directly affect companies operating in ancillary businesses.

Both Congress and the White House are working to clarify the federal position on cannabis while still protecting states’ rights. In 2013, then U.S. Deputy Attorney General James Cole issued an enforcement policy memo to all U.S. attorneys detailing the priorities of the Department of Justice (“DOJ”) when enforcing federal drug laws in states that legalized or decriminalized marijuana. The ‘Cole Memo’ ultimately emphasizes the need for robust state regulation of marijuana. The memorandum “rests on its expectation that state and local governments that have enacted laws authorizing marijuana-related conduct will implement strong and effective regulatory and enforcement systems that will address the threat those state laws could pose to public safety, public health, and other law enforcement interests.”

In February 2014, the White House and the Department of the Treasury gave a roadmap for conducting transactions with cannabis companies operating within state regulations. The most sweeping federal reforms to 26 First Harvest Real Estate Fund 1, LP Private Placement Memorandum Dated March 26, 2016 date, however, have come from Congress in the federal spending bill that passed both Houses in June 2015. Congress voted to protect state medical marijuana and hemp laws from federal interference and cut the DEA’s budget. As an example of increased support for the removal of federal laws banning medical marijuana, the medical marijuana-protecting amendment passed the House 219-189 and became law last year and was accepted by a larger 242-186 majority this year, with even more Republican members’ support.

The Senate also introduced The Compassionate Access, Research Expansion and Respect States (CARERS) Act in March 2015, co-sponsored by Senator Rand Paul (R-Ky.) and now by 16 additional U.S. Senators, which seeks to drastically reduce the federal government's ability to crack down on state-legal medical marijuana programs, open the banking system, reclassify cannabis’ Schedule 1 drug rating and encourage more research through several major changes in federal law. This legislation currently is waiting for the Senate Judiciary Chair to grant the bill a hearing.

From a budgetary perspective, a 2010 study for the Cato Institute estimated that legalizing marijuana could generate a combined $17.4 billion in new state and federal tax revenues and savings on expenditures related to the enforcement of marijuana prohibition.

**Ancillary Cannabis-Related Businesses:**

As more states enact cannabis legislation, the demand for cannabis-related products and services grows. The rapid expansion of the cannabis market combined with more sophisticated management teams and business models entering the market has spurred the development of numerous cannabis-related niche markets. These ancillary markets that do not physically ‘touch the plant’ include infrastructure and support for the cannabis industry in such areas as social media, security, consulting, delivery systems, financial services, software & high-tech, electronic hardware, infused products, extracts & oils, hemp production, ancillary cultivation solutions, and retail. The federal government still classifies cannabis as a Schedule 1 substance, which leaves many traditional businesses fearing reputational and legal risks of serving the cannabis industry. However, ancillary businesses that do cater to the legal cannabis industry are well positioned to benefit from the growth in the industry.