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Ashes to ashes

Evan Lorenz writes:

Never mind the vogue in working from home. Commercial real estate prices have climbed by 9% since the virus struck, according to Green Street's Commercial Property Price Index, as an ecommerce-powered leap in the value of industrial warehouses—up a cool 41%—has more than offset weakness in the office and mall property sectors (down 6% and 13%, respectively).

Now in progress is a short study of another island of commercial real estate prosperity—or, rather, we are about to propose, dwindling prosperity. Innovative Industrial Properties, Inc. (IIPR on the New York Stock Exchange), the largest and most successful cannabis real estate investment trust, is the specimen under the *Grant's* lens. In preview, we're bearish on it.

Innovative, brainchild of the real estate entrepreneur Alan Gold, was founded in 2016 to finance the unbankable marijuana business. Although 37 states have legalized marijuana for medical or recreational use (California, of course, was first), cannabis remains a Schedule I drug—i.e., a harmful substance that has no accepted medical use—alongside heroin, under federal law.

Under banking law, too. Barred from conventional financial channels, marijuana companies pay a punitively high cost of capital. Sale-leaseback transactions with companies like Innovative have been one of the few reliable sources of funding.

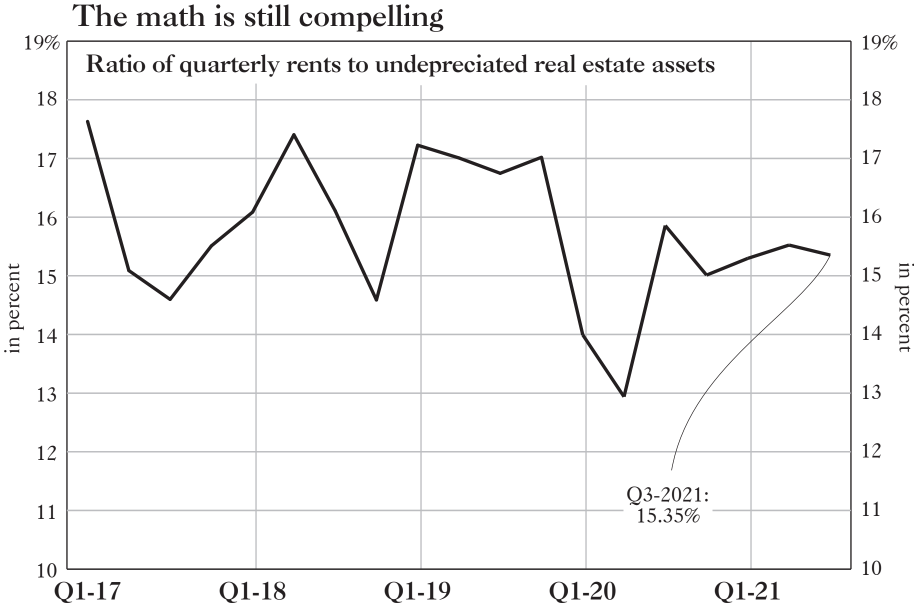
Say that you, gentle reader, grow Mary Jane. You need more than a hoe. Innovative stands ready to finance your HVAC, lighting and security systems. It will pay top dollar to buy your operation—indeed, a hefty premium to cost, along with bigly tenant improvement allowances. The sale completed, it will lease your property back to you in triple-net fashion. Under a triple-net lease, the tenant is responsible for all building expenses, including taxes, insurance, maintenance and utilities. Notice, too, that the lease rate is based on the generous price at which you agreed to sell.

Even IIPR's stock listing has a regulatory narrative attached. A 2013 memorandum by an Obama-era attorney general, James Cole, gave safe harbor to medical-marijuana operators that abide by state laws; Trump's first attorney general, Jeff Sessions, rescinded the Cole memo. As a result, the New York Stock Exchange and the Nasdaq refuse to list new cannabis-related securities. IIPR's Dec. 1, 2016 initial public offering came in just under the wire, and its Big Board listing is thereby grandfathered. It's for these reasons that Newlake Capital Partners, Inc., an upstart cannabis REIT that went public on Aug. 13, trades over the counter.

IIPR started its public-company career showing one property on its balance sheet, at a $30.1 million cost. As of Sept. 30, it owned 76 properties, encompassing 7.5 million square feet of rentable space across 19 states, at a cost of $1.5 billion.

In the third quarter, rental income

The math is still compelling



source: company reports

Innovative Industrial Properties, Inc. at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
revenues	$182.7	$116.9	$44.7	$14.8	$6.4
net income	105.3	64.4	22.1	5.6	-0.4
funds from operations	149.3	92.4	30.7	8.3	0.5
FFO/share	6.07	4.72	2.88	1.13	0.15
shares	26.3	19.6	10.7	7.3	3.5
cash	127.3	126.0	82.2	13.1	11.8
investments	554.4	619.3	119.6	120.4	0
debt	431.9	136.7	134.7	0	0
total assets	2,102.1	1,768.1	745.9	281.5	80.0

* The 12 months ended Sept. 30, 2021.

source: company reports

amounted to 15.4% of undepreciated assets. As triple-net leases entail no operating expenses, that's the equivalent of a 15.4% cap rate. Today, for perspective, you'll pay 3% for a warehouse in a gateway city and 9% for a sad brick-and-mortar store.

Innovative has funded most of this growth with equity instead of debt. From the Dec. 1, 2016 IPO through the third quarter, the share count has grown by 645%, to 26.3 million, though the dilution seems manageable. From the first quarter of 2017 through the third quarter of 2021, rent revenue jumped by 3,965%, adjusted funds from operations by 13,142%.

As to the balance sheet: On Sept. 30, Innovative's debt stood at $431.9 million compared with $681.7 million in cash and investments (and $417.5 in commitments to fund additional tenant improvements). The company's senior unsecured 5½s of 2026, which change hands at $106.70 to yield 3.8%, are rated triple-B-plus by Egan-Jones Ratings Co.

Lean is the watchword at Innovative. Management holds two conference calls each year, rather than the customary four. The head count is (or was at the end of September) 19, of whom few toil in the investor-relations department, or so we surmise from our unanswered calls and emails.

No question, though, that demand for the type of capital that Innovative provides has grown. Sales in the regulated cannabis market jumped to $20 billion in 2020 from $13 billion in 2019. "With the illicit cannabis market still making up approximately $66 billion of overall sales in 2019, there continues to be tremendous potential to move that activity into the regulated market," Innovative CEO Paul Smithers told the audience on the Aug. 5 earnings call. State laws magnify the capital needs of the industry as growers must build facilities in every state in which they operate.

Of the eight analysts who cover IIPR, six say buy and none says sell. While short interest sums to 6.2% of the float, it's not clear whether bears are betting against the REIT or whether holders of IIPR's senior unsecured 3¾ convertible notes of 2024 are hedging their equity exposure. Over the past 12 months, officers and directors have sold 30,215 shares for proceeds of $6.2 million while no insider has bought.

The shares trade at 44.9 times trailing funds from operations and pay a 2.3% dividend yield, but there are facts to mitigate that optically towering valuation. Thus, Innovative is able to buy properties at around a 15% cap rate, while trading, itself, at a 2.7% cap rate, so the spreads on acquiring new properties are fat and beckoning. For comparison, Prologis, Inc., a large industrial REIT, is priced at a 2.9% implied cap rate while its portfolio yields an economic cap rate of 3.5%.

The math could be changing, however. For one thing, large, multistate operators (MSOs) have grown big enough to tap the public debt market themselves. Thus, in June, PharmaCann, Inc., Innovative's second largest tenant, issued first-lien bonds due 2025 with a 12% coupon. In August, Ascend Wellness Holdings, Inc., the company's No. 4 tenant, issued a first-lien bond due 2025 at a 9.5% yield. The 12s have subsequently rallied to $108.50 to yield 8.3%. Through late October, American cannabis companies have raised a total of $7 billion in debt and equity capital.

"What you see now is a little bit of a bifurcation in that really big MSOs and publicly traded MSOs have significant access to unsecured debt and other kinds of debt structures, and that is a competing capital source," John Massocca, who rates IIPR a hold for Ladenburg Thalmann & Co., Inc., tells me. "What you've seen is IIPR and competitors have gone to the smaller MSOs and single-state operators who can't do these unsecured debt deals at this point in time. That isn't to say it is exclusive and there aren't opportunities to deal with larger MSOs, but those deals have become more expensive in terms of being lower-cap-rate transactions and are scarcer."

Underwriting early-stage companies is never easy (ask any venture capital manager), and the fact that cannabis remains illegal at the federal level doesn't help matters. On July 19, 2019, IIPR signed a sale-leaseback agreement for property with DionyMed Brands, Inc.—a company that filed for bankruptcy protection three months later.

To date, this is the only default in Innovative's portfolio, but a scan of the roster of IIPR's top five tenants, which collectively make up 47% of third-quarter rents, suggests that it might not be the last. Two of the five, SH Parent, Inc. (12% of rents) and Ascend Wellness (8%) are unprofitable. (The SH Parent sighting comes from a presentation relating to an aborted merger with a SPAC earlier this year.) Kings Garden, Inc. (8%) and Green Thumb Industries, Inc. (7%) are in the green, though we were unable to find financial information on PharmaCann, Inc. (12%).

An April 2020 report by Grizzly Research, LLC, a short-sale activist, dug into the issue of tenant quality and the risks it poses to Innovative's portfolio. PharmaCann was left reeling in 2019 after a failed merger with MedMen Enterprises, Inc. and the resignation of co-founder and CEO Teddy Scott. Nevertheless, in the wake of those events, Innovative purchased a property from PharmaCann for $18 million with an extra $7 million's worth of tenant improvements besides. PharmaCann had paid $1.75 million for the same building one year earlier.

Was this an example of rescue financing dressed up as a sale-leaseback? It would be well for Innovative if its customers avoided financial problems. Leases can be rejected during the bankruptcy process, and if Innovative were wrapping loans into its sale-leaseback agreements, it could face a pair of problems. First, at the expiry of a lease, growers may not be willing to pay the nosebleed rents that serviced prior credit extensions. Second, given that many grow centers are situated on the edge of cities and towns—no one wants to live near a pot farm—Innovative's heavily capitalized properties have limited use for non-cannabis businesses.

Grizzly documented other buildings for which Innovative paid a large premium to the prior sale, as well as properties whose tenants failed to meet contracted construction schedules even before the start of virus lockdowns. "When these companies end up not being able to pay the rents, instead of telling investors that they have bad renters, [Innovative's management does] another sale-leaseback with the company to give them short-term liquidity in order for them to pay the rent and to keep their books looking good on paper," Grizzly CEO Siegfried Eggert tells me.

An Innovative-issued press release following the Grizzly report said that the short seller demonstrated a "fundamental misunderstanding of IIP's business model. As such, most of the report's content does not warrant a response." The release added that Chairman Gold "has not sold a single share of common stock in IIP since inception" and remains fully committed to the company.

To Innovative's credit, the potential issues Grizzly highlighted have not yet led to a collapse in earnings or in its stock price. To the short seller's credit, Gold has sold $1.9 million's worth of stock and $173,366 in preferred shares over the past 12 months.

Innovative can earn the yields it does because the continued federal proscription of marijuana denies growers formal banking accommodation. But politics, too, are changeable. A Nov. 9 poll by Gallup found that 68% of Americans support legalization, and, as already noted, 37 states have legalized cannabis for recreational or medical use.

Two Mondays ago, Rep. Nancy Mace (R., S.C.) introduced a bill to legalize cannabis, adding the first Republican entry to three other such pieces of legislation wending their way through Congress. "[G]iven the bipartisan nature of cannabis, this bill shows that it is an easy win for both Democrats and Republicans heading into the mid-terms to win favor with voters and especially swing voters," Jefferies, LLC analyst Owen Bennett wrote on Nov. 7 before the details of the bill were unveiled.

Legalization has multiple risks for IIPR, as the company concedes in its 10-Q report:

> If any of the proposed bills in Congress became law, there would be further increased competition for the acquisition of properties that can be leased to licensed cannabis operators, consolidation of cannabis cultivation facilities for more cost efficient, larger scale production and manufacturing may occur, and such operators would have greater access to alternative financing sources with lower costs of capital.

In other words, legalization would allow more alternatives to Innovative's pricey sale-leasebacks. Perhaps Mr. Market will start looking for alternatives to Innovative's pricey common shares.

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