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TOKYO SMOKE: Building a Retail Cannabis Brand (A)

R. Chandrasekhar wrote this case under the supervision of Eric Janssen solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In late 2016, Alan Gertner opened his laptop at his Toronto apartment and googled “pitch deck template.” While he skimmed the search results, he began to see an irony: only a few months ago, he had been an employee at Google Inc., ranked by *Fortune* magazine as the best company to work for five years running.[[1]](#footnote-1) He had been travelling the globe and doing everything he thought he wanted to do in the corporate world. But lately, he had been feeling uneasy; wanting to get away from it all, he had quit. Only a few weeks ago, he had decided to start his own business, and he was now chasing an entrepreneurial dream in which the destination was clear to him, but the road map was not.

The future he had chosen was cannabis, and the segment he had chosen within the cannabis value chain was brand building. Unlike cannabis manufacturing, which seemed to have found its bearings in Canada with licensed producers (LPs) firmly ensconced in a pecking order, cannabis retailing was on unsteady ground, providing an opportunity for the kind of breakthrough ideas Gertner had in mind.

The triggers had come from changes in Canadian public policy. In April 2014, the federal government had allowed LPs to produce medical cannabis on an industrial scale and to distribute it, by mail, to patients holding permits from Health Canada.[[2]](#footnote-2) In April 2016, it had announced that, effective August 2018, it would deregulate recreational cannabis.[[3]](#footnote-3)

A new opportunity was opening on two simultaneous fronts—medical cannabis and recreational cannabis. For Gertner, a new opportunity for building a cannabis brand had taken shape.

While Gertner had savings to live off for a while, he did not have the capital required to kick-start a business, and he was not familiar with raising money in the capital market. Notwithstanding the premium that a manufacturing license carried, the cannabis market was far from mature. Private investors were wary of a market that had seen few success stories so far.

Gertner’s own footprint in the market was limited to a 23-square-metre concept store, called Tokyo Smoke, he and his father, Lorne Gertner, had opened in early 2016 in downtown Toronto; here, walk-in customers could have a cup of coffee while enjoying free-wheeling conversations about cannabis and what it was all about. The store had garnered some visibility in the media for its design.

Wondering where to begin to look for capital, Gertner began to prepare his pitch deck.

ALAN GERTNER

Graduating with a business degree from Western University in Ontario, Gertner had spent a few years working for the management consulting firm Oliver Wyman in New York before joining the Google head office in California as a member of the company’s newly formed global business strategy team. After a few years in Silicon Valley, he relocated to Singapore to head the company’s travel business unit in Asia. Ensuring that people used the Internet more often and were comfortable making their travel bookings online, rather than through travel agents, was one his main responsibilities. A large part of his job involved securing product adoption by changing user behaviour. For the next decade, he was also focused on a personal goal: winning at work. He was spinning in a corporate loop of sorts—do well, get promoted, and get a raise—and he revelled in the routine.

He had been in Ghana in early 2014 with a few other Google employees when he decided, on a whim, to attend a voodoo ceremony with a friend, and the journey to reach the ceremony turned out to be fortuitous. During the four-hour drive into rural Ghana, he got talking with the local guide about life and times in general. Gertner was in a mood to unburden himself, and he told the guide that he was feeling less and less anchored and did not know what to do but was considering quitting the job at Google. The guide was quick to question the idea of quitting a good job. When Gertner asked the guide what made him get out of bed every day and go to work, the guide told him that his motivation to get up every morning and get to work was straightforward: he worked either on things he loved or to support people he loved.

This revelation hit Gertner, who realized he was doing neither at that point. He was working for self-aggrandizement, intent on nothing more than the next promotion and the next raise. He was losing relationships in the process, but it did not seem to matter. With this new perspective, he could clearly see why he was often feeling stuck.

He decided that he would need to quit the corporate job in order to move from winning at work to winning in life. He also decided that, before quitting Google, he would take time off and have some fun. At a fundamental level, he was in search of a rationale for his decision to quit a great job in a great company; he wanted data, and he wanted evidence. In a bid to understand what winning at life would ultimately entail, he developed a spreadsheet, which he started filling in each day. He packed this with minutiae about the day’s activities, the day’s weather, and details like whether he had shaved or not; he noted how every little thing made him feel; and, he gave each day a score based on how happy he was, how fulfilled he was, and how meaningful he felt. He kept the spreadsheet, which was meant to track his feelings and quantify his happiness day to day, for six months. His conclusion was that happiness for him meant being part of something bigger than himself. He wanted to take on big challenges and build a community around him.

Gertner quit Google at the end of six months and went to Toronto, where he reconnected with friends and family he had left a decade ago. His family had deep-rooted connections to cannabis. His grandmother had moved to Humboldt, in northern California, the home of cannabis in the United States, and 20 years ago, his father had started a company in Canada with a license to grow federally regulated medical marijuana. In his younger years, when cannabis was illegal in Canada, Gertner had smoked cannabis with friends behind a convenience store. He recalled feeling panicky in the freezing cold and being keen on running away before being caught. The experience had often haunted him. He thought he might have had a different experience around cannabis consumption if there had been more education and a better understanding around cannabis at the time.

Back in Toronto now, he witnessed the way changes in public policy had opened opportunities of a lifetime for budding business entrepreneurs. He and his father began to consider ideas about what the retail cannabis experience could look like in this unfolding environment. Cannabis was being liberalized within both Canada and the United States, and this in turn was unlocking new doors around the world. Gertner wanted not only to be part of the changes but to lead them from the front.

The untapped market of first-time cannabis users was a huge prospect. Being part of someone’s first experience with the brand would provide a competitive advantage. Gertner thought of the parallel with tobacco products: Gertner was convinced that, just as consumers picked tobacco brands and stayed with them—the chosen brand representing the customer and providing an identity, generally for life—cannabis brands would have a similar relationship with first-time users.

CANNABIS INDUSTRY

Cannabis was known variously as marijuana, pot, grass, weed, hash, and hashish. The aromatic herb *Cannabis sativa* contained over 80 highly potent chemical compounds called cannabinoids. Cannabis had been part of the social custom for centuries in the countries of Asia, Africa, and South America, where it provided relief from pain and relaxation from stress. It entered North America in the late 1960s and soon evolved into a symbol of protest over prevailing social norms that promoted racism, poverty, and inequality.[[4]](#footnote-4) Since its usage was known to carry health risks—both physical risks to the heart and lungs when it was smoked, and mental risks including disorientation in time and space—cannabis was listed as a scheduled drug in both the United States and Canada.

Violations of regulations pertaining to the cultivation, distribution, and use of cannabis had become frequent, and this led, over time, to public perceptions that identified the product with criminality. The costs of regulation were also high for governments. In Canada, for example, monitoring home-grown cannabis cost the government CA$20 million[[5]](#footnote-5) per year. One of the reasons Canada legalized medical cannabis in April 2014 and allowed industrial-scale production was to reduce the cost of oversight by 90 per cent.[[6]](#footnote-6)

Forty countries in the world had some form of decriminalized cannabis. Nearly 35 per cent of the global population, or 2.7 billion people, consumed cannabis in some form around the world. The industry in the United States alone generated revenues of more than $5 billion per annum and was growing at 20 per cent year on year; 133 million people in the United States, or 30 per cent of the U.S. population, were consuming cannabis.[[7]](#footnote-7) This pre-existing customer base was a unique feature of the market. New retail entrants to the industry, for example, did not have to focus on customer acquisition or convince people to smoke cannabis; rather, they just had to provide a safer and more modern experience for cannabis consumption.

The industry had an affinity with related sectors such as tobacco (since smoking was one of the ways to consume cannabis), alcohol (since both products provided relaxation), and pharmaceuticals (since cannabis also provided relief from pain). Recreational cannabis, for example, provided a natural replacement for alcoholic beverages: alcohol provided a “buzz” whereas cannabis generated a “high.” Tobacco products, however, did not offer a potential for replacement—not only because their usage was more frequent during the day but also because tobacco usage rates were declining. Many tobacco companies were tracking LPs as acquisition targets. The major disadvantage, however, was the association of tobacco with chronic ailments like cancer. Big pharmaceutical companies were investigating medical cannabis as a potential “blockbuster” drug—defined as a drug with more than $1 billion in sales per year. Some of these companies were conducting low-profile clinical trials with cannabis, keeping these trials unofficial for reasons of competitive intelligence. Bayer Healthcare AG had acquired, in 2013, distribution rights in U.K. and Canadian markets for a synthetic formulation manufactured by GW Pharmaceuticals Plc, a U.K. cannabis firm.[[8]](#footnote-8)

The cannabis derivatives market was expected to have a higher growth potential than the cannabis market. Examples of derivatives included oils, mouthwashes, mints, creams, and topical preparations. For example, cannabis beard oil, also known as hemp oil, was known to be good for human skin.[[9]](#footnote-9) The cannabis accessories market, comprising products like vape pens, was also set to grow massively in the coming years.

In contrast to modern farming—which was mechanized, particularly in North America—cannabis production was an artisanal activity characterized by batch processing, which was costly and not conducive to high productivity. It was also energy intensive, and costs were associated with following regulatory protocols—setting the stage for compliance alone required an up-front investment of $500,000 for a new entrant.

Although Health Canada regulated the production and distribution of medical cannabis, it left the pricing of end products to market forces. The selling price of medical cannabis was thus a function of the cost of production for individual LPs. The supply side of medical cannabis was relatively consolidated. LPs were required to distribute medical cannabis direct to consumers and only by mail. A typical smoking “joint” contained just under 0.50 grams of cannabis, and a single intake of smoke, or a “hit,” contained about 0.05 grams. Medical cannabis was segmented based on product attributes, and quality evaluations were as precise as those of financial dealers grading investment bonds. For example, an A grade cannabis had loose buds, an AAA grade had tight clusters of flowers, and a BB grade left black ash when burned.

Unlike medical cannabis, which was purchased based on outcome-based logic, recreational cannabis purchases were influenced by emotive factors, and companies had to address these factors in marketing their products. Consumers had to deal with product stigmatization. They relied on user reviews, peer referrals, expert content, and celebrity endorsements as the basis for their purchase decisions. The advent of social media had also changed the landscape for marketers.

Canada was poised to lead the cannabis revolution for four reasons. First, it had a marquee list of industrial-scale producers. The country had over 30 federally regulated LPs, 11 of which were publicly traded companies complying with the rigour of statutory protocols. Second, Canada was not only the first country in the world to have a federally regulated medical cannabis program but was also the first among G7 nations that was planning to legalize recreational cannabis. Its product compliance structure was expected to be a model for other countries. Third, Canada had an established domestic market. Management consulting firm Deloitte estimated that 22 per cent of Canadians used recreational cannabis on a regular or semi-regular basis and another 17 per cent would consider trying it once it became legal.[[10]](#footnote-10) Fourth, Canada was the only country in the world that was exporting cannabis legally to other countries. Cannabis was expected to rank, sooner or later, among the country’s nation-defining exports, like salmon, maple syrup, and lentils.[[11]](#footnote-11)

TOKYO SMOKE

Gertner recognized that retail and branding would be an important part of the cannabis value chain. The storefronts that had previously sold “weed” in desolate and indistinguishable surroundings of the back alleys of cities like Toronto reinforced images of a dark and shadowy world. The changing order of cannabis required a changing order of retailing.

Starbucks Corporation (Starbucks) struck Gertner as a model for transforming cannabis retailing. Cannabis was currently perceived as nothing more than a source of potency, much as coffee was perceived before Starbucks entered the scene. For decades, black coffee had been the staple beverage for many in North America. They started the day with it, trying to get as much caffeine into their system as quickly as possible, and they did not bother much about taste. Coffee came in a single variety—black—but Starbucks provided choices: Americano, cappuccino, doppio, espresso, latte, mocha, macchiato, and so on. It brought in taste as an important factor, dressed up its stores, and employed smart-looking and customer-friendly counter staff called baristas. Starbucks also played a pioneering role in educating the masses about the “boutique” coffee experience that became its trademark. Not surprisingly, Starbucks went on to garner a 25 per cent share of the coffee market in the United States. It was noteworthy that Starbucks was focused on the retail end of the coffee chain and was not involved in coffee cultivation other than by owning an experimental farm in Costa Rica for the limited purpose of innovation in coffee.[[12]](#footnote-12)

Gertner’s plan was to follow the Starbucks trail. He planned to build a modern cannabis brand on the back of retail stores and to license the brand to LPs, beginning in Canada, and then in the United States and the rest of the world. He started by leasing a 23-square-metre space in downtown Toronto as a concept store. While working for Google in Tokyo, he had been drawn to Japanese design, which was characterized by craftsmanship and elegance. Wanting to integrate that with the cannabis culture that he was launching, he called the concept store Tokyo Smoke.

The store would not sell cannabis but would provide a cannabis experience within the ambience of a coffee shop. Guests could ask questions about cannabis and get answers. The idea was to open a conversation on cannabis in order to demystify it for ordinary Canadians and help them make informed choices about cannabis use. The store would serve gourmet coffee; clothing, like branded shirts; and accessories, like vaporizers and artisanal ceramic pipes. Customers could leaf through design magazines and books, look at a few Lego models, and of course, grab a cup of coffee made from sustainably grown and ethically sourced beans.

The concept store would help in collecting data, which was hard to come by in the cannabis market. Walk-in customers would be more willing to drop their guard and share their consumption preferences in an environment that was non-judgmental than during a survey over the phone, for example, when they would be on their best behaviour. The store would also help develop a nomenclature that Gertner saw as critical to the success of cannabis retailing.

Gertner also equated Tokyo Smoke with a cultural movement aimed at creating an immersive physical experience across three different verticals—coffee, clothing, and cannabis—which he believed was “the lifeblood of the creative class.” He visualized Tokyo Smoke retail stores diversifying into activities like hosting gallery shows in a bid to fortify the perception of Tokyo Smoke as a lifestyle brand.

ISSUES BEFORE GERTNER

A new enterprise would usually have two sources of funding. The first was the seed capital, which came from friends, family, and personal savings. This seed financing would be used to build a product or service and get early traction in the form of pilot customers. The second source of financing, known as series A, was raised after the business was launched and came from professionals like angel investors and venture capital firms. Series A funding was used for scaling up operations, building a management team, hiring staff, broadening a product line, ramping up sales, and taking growth to the next level.

Having brought in his personal savings so far, Gertner was now in the middle of mobilizing seed funding. At this stage, he had to factor in an important piece of the puzzle: business valuation. The valuation of a business enterprise as a going concern was equivalent either to its net worth or to what a sensible buyer would be willing to pay for it. For a new venture like Tokyo Smoke, however, the valuation would be determined by how much equity the promoter was willing to provide in exchange for money. Gertner had to decide how much equity he would give in exchange for the money that friends and family would bring in. For example, if he were to give 5 per cent of the enterprise in exchange for $50,000 capital, the enterprise would have a valuation of $1 million. If he were to raise $200,000 from friends and family and distribute 10 per cent of the enterprise among them, he would be going for seed A financing with a $2 million valuation.

Completing a seed round at the right valuation was important to bring in the right investors and minimize dilution. It would also help demonstrate to series A financiers how he had managed, invested, and capitalized on the seed funding. Investors at either stage, however, would be concerned with three things: how much money Tokyo Smoke intended to raise; how it would deploy the money; and how it would pay it back to investors.

Gertner saw four core propositions for investors, whether seed or series A. First, legalization would allow Canada the opportunity to take cannabis global as a nation-defining export. Second, cannabis had an established customer base of 35 per cent of the global population and 25 per cent of the Canadian population. Third, Tokyo Smoke would be focused on the retail end, which would be the major source of value in the cannabis chain. Finally, Tokyo Smoke would build cannabis brands, license them to manufacturers, develop customer relationships for them, and establish a network of licensed stores—first, in Canada and the United States, and over time, in the rest of the world.

A major issue Gertner would have to address was the stigma associated with the product in the public mind—there were parallels with tobacco and alcohol. Investors would be eager to fund an enterprise that would be involved, as Tokyo Smoke was planning to be, in educating the public about cannabis. They would also be looking for a scalable business model.

Gertner wondered what his investment pitch should be.

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