THE GLOBE AND MAIL

It's time for Canada's cannabis companies to get their governance houses in order

By Ian Robertson
Originally published in the The Globe and Mail on Nov. 12, 2019

In the months before Canada legalized recreational cannabis, companies in the new sector rushed to get established. Since Oct. 17, 2018, it's become clear that many didn't put sufficient effort into building their boards or instituting governance best-practices.

With more than 200 publicly listed cannabis companies in Canada, there are significant deficiencies when it comes to board diversity (both of individuals and skills), executive compensation, CEO-succession planning, director independence, and corporate checks and balances.

Until recently, lofty expectations meant investors were willing to look the other way. Indeed, this past year was supposed to be a boom for sector participants, with skyrocketing valuations, budding earnings and celebrity status being thrust upon key industry executives. Unfortunately, with the speculative bubble bursting, a year of promise quickly turned into a year of struggle.

From the get-go, producers faced national supply shortages while the illicit market continued to flourish. Earnings consistently fell below expectations, with even some of the larger companies being forced into cost-cutting measures; last week, Hexo Corp. layed off 200 employees to "ensure the long-term viability" of the company.

There have also been high-profile compliance and regulatory issues at CannTrust Holdings and Namaste Technologies Inc. that cast a shadow on the industry and put a spotlight on governance.

In the merger and acquisition space, we've seen a mixed bag of success: In June, shareholders of Canopy Growth and Acreage Holdings agreed to a first-of-its kind cross-border plan of arrangement while other deals (e.g. Green Growth Brands' proposed takeover of Aphria and MedMen Enterprises' acquisition of PharmaCann) fizzled. And, with more companies facing funding constraints, consolidation deals that would make a lot of sense to shareholders have suffered from a failure to launch.

With all these struggles and the subsequent drop in valuations, market confidence has waned.

Some industry observers are forecasting a rebound as edibles, beverages, and extracts are slated to hit shelves early next year. But given the events of the past year, and the number of shareholders who've been burned, expect investors to shift their focus to how these companies are run.

After one year of legalization, the honeymoon is over.

Cannabis Companies Poised to Become Activist Targets

There has not yet been a glut of shareholder activism in the cannabis space but the early signs are there that it's coming. In 2019, There were four proxy contests at cannabis companies in 2019, with two of them being transaction related.

Expect the cannabis industry to be a bigger target in 2020 because of poor financial performance, lagging governance practices, a push for M&A, and low shareholder turnout.

The good news for boards of directors at cannabis companies is that there are immediate steps they can take to improve their governance and protect themselves:

Ensure the right board and the right leadership for the right time.

Despite the industry's infancy, there has been a high level of executive turnover in recent months, as boards have pushed aside entrepreneurial founders in favour of managers with operational skill sets who can strengthen balance sheets. Bruce Linton, co-CEO and founder of Canopy Growth, was the industry's most high-profile victim. At the board level, companies should consider a similar approach to refreshment. Directors who have been with the company since inception may be great entrepreneurs but they might not have the appropriate skill sets to provide oversight of operations, or lead a public company.

Know your shareholders and their concerns.

It's important that companies understand the composition of their shareholder base. Over the past two years cannabis companies, particularly the larger ones, have seen an increase in institutional holders, which presents a whole new paradigm: Firstly, institutional investors place more scrutiny on companies for things like governance. Secondly, proxy advisory firms Institutional Shareholder Services and Glass Lewis –firms tasked with providing vote recommendations on proxy items – will now have a say in shaping the future of a company by means of their proxy vote suggestions at the next annual general meeting.

We encourage companies to get ahead of the game. Last week, iAnthus Capital Holdings, for example, announced board changes "designed to align with Glass Lewis and Institutional Shareholder Services' standards for corporate governance."

Ensure alignment with shareholders.

Performance share units, shares granted to executives based on corporate performance, are considered best practice in holding management accountable and aligning their goals with shareholders' goals. In contrast, and out of line with the TSX 60, cannabis companies largely still use stock options as their primary long-term investment plan vehicle.

Undertake a deep and critical self-analysis.

Put your company in a constant state of internal review, with an eye toward identifying governance deficiencies that could attract activists: How closely related are directors? Do you have checks and balances in place to ensure no fraud or regulatory breaches are taking place? Is your board diverse enough? Do your current directors have skin in the game? Governance issues, or perception of governance issues, provide low hanging fruit for an activist as the failure to address basic governance concerns is used as evidence that at best a board doesn't care and at worst is self-dealing.

Without the shield of market optimism, cannabis companies who fail to institute governance best practices will be vulnerable. Restoring confidence starts with an approach to governance designed to raise the bar for the industry.

Ian Robertson is executive vice-president of communication strategy at Kingsdale Advisors.

KINGSDALE Advisors

TORONTO
The Exchange Tower
130 King Street West Suite 2950
P.O. Box 361 Toronto ON M5X 1E2
T 416.644.4031
TF 1.888.683.6007
F 416.867.2271

NEW YORK
745 Fifth Avenue, 5th Floor
New York NY 10151
T 646.651.1640
TF 1.844.740.3227
F 631.504.0492

contactus@kingsdaleadvisors.com
www. kingsdaleadvisors.com