MARIJUANA
An Emerging Industry's Impact on Industrial Real Estate

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Colorado's emerging marijuana industry has boosted Denver's industrial market in recent years and offers insight to other markets in the United States that are considering legalizing either medical or recreational marijuana.

Marijuana's influence on Denver's industrial market has been building for over a decade. The industrial space needed to cultivate and manufacture the product is increasingly in demand. The first wave of demand occurred in late 2000 when Amendment 20 legalized marijuana for medical purposes, followed by a stronger push in November 2012 when Colorado voters approved recreational marijuana use. Regulations were established in May 2013 and became effective January 1, 2014. In August 2013, the federal government issued guidelines that would protect state-legal marijuana businesses from prosecution, resulting in the influx of out-of-market investors into Colorado and a subsequent increase in demand for appropriately zoned industrial property.

While product demand is difficult to gauge due to the nature of the industry and lingering off-market volume, tax revenues provide some insight into consumption and production trends. According to the State of Colorado Department of Revenue, monthly tax, fees, and licenses collections have steadily grown through the first seven months of 2014. July 2014 collections were 110.5 percent above January 2014 collections and year-to-date collections already top $33.6 million through July.

Looking ahead, the Governor's office has budgeted for a $134 million revenue contribution from the marijuana industry in the fiscal year beginning July 2014. About half of the tax revenue collected from retail and medical marijuana currently occurs in the city and county of Denver, followed by Boulder, Pueblo, and Jefferson counties. An estimated 44 percent of retail sales are made by out-of-state visitors in the Denver market.

Despite legalization, it is expected that a significant volume of marijuana production and consumption is still occurring on the black and grey market to avoid taxation. Grey market pricing is approximately two thirds that of retail, while black market pricing is considerably lower. Thus, although state and local governments are increasingly improving regulatory controls and processes, the industry remains challenging to analyze, as does its real estate impact.

INDUSTRIAL REAL ESTATE IMPACTS

Denver marijuana growers and manufacturers account for at least 3.7 million square feet of occupied industrial space according to CBRE research — making up about 3 percent of the existing warehouse footprint. The timing of marijuana's legalization provided a boost to an already recovering industrial market in Denver since the recent recession; however, the emerging industry clearly contributed to rent growth, heightened absorption, and declining vacancy. While the marijuana industry has not directly resulted in new industrial construction, it has indirectly supported new construction by strengthening market fundamentals.

Absorption related to marijuana cultivation has been largely concentrated in underutilized Class B and C industrial assets and leases are generally secured at above-market rates. Growers' willingness to buy or lease at above-market rates stems from competition over a limited supply of warehouses in areas zoned for cultivation; speed to market tactics that are important in an emerging industry and profitable margins — all which result in a willingness to pay two to three times market rates. Lease rates for grow facilities have tripled that of traditional users and although initial sales prices were marginally above market, within months of the federal guidelines, prices more than doubled. However, of the estimated 3.7 million square feet currently occupied by grow operations, it is estimated that only half is in full production. Recently, investor sentiment has waned with sales prices leveling and in some cases, even declining.

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The typical grow operation requirement relies on heavy power for high-intensity lighting that replicates the sun and heavy HVAC requirements to mitigate the heating effects from such lights. Security is a priority for grow tenants and may be addressed by view obstruction tactics like dry walling over windows or signage from previous tenants that does not advertise the facility's current inventory and function. Grow operations also require dehumidifiers, carbon filters, carbon dioxide, and ozone generators. Leases typically range from three to five years. The average facility size is 10,000 to 20,000 square feet; however, grow operations in the Denver market range from 2,000 to 100,000 square feet.

WEIGHING RISK

Institutional capital is not pursuing investment opportunities related to the marijuana industry because it is an illegal activity at the federal level. The primary real estate plays are local and private investors who display a spectrum of investor sophistication ranging from one-off deals to savvy owners who have embraced the industry and will expand not only within the local market but also to other markets as legalization spreads.

The primary risk owners and investors incur is qualifying prospective tenants, while also preparing the building with expensive power upgrades. For this reason, landlords are securing transactions with pre-paid rent, hefty security deposits, and creative lease language.

Mold is not a risk to landlords and investors because grow operations are not legally allowed to be hydroponic. A lingering smell is also not a concern because the plant odor dissipates when the plants are removed.

WHAT MARKETS ARE ON THE HORIZON?

Alaska, Oregon, and Washington, D.C. voted in favor of legalizing recreational marijuana in the most recent November elections following in the footsteps of Colorado and Washington. In the next few years more states may move in this direction amid growing public support and federal relaxation. Twenty states and Washington, D.C. already allow for some form of medical marijuana use and 16 states plus Washington, D.C., have decriminalized the possession of small amounts of marijuana.

As discussed earlier, legalization brings much-needed tax dollars into government coffers. NerdWallet recently estimated U.S. tax collections from marijuana would top $3 billion annually if all fifty states legalized recreational marijuana use, with California taking in the largest share of over $519 million annually.

There is much to be learned from Colorado's venture into legalized marijuana and how this emerging industry creates both risks and opportunities in industrial real estate. What is clear is that Denver's industrial market benefitted from the new demand source and the tenant's willingness to pay a premium. As growing public support meets struggling government budgets and legalization spreads beyond the current handful of states, it behooves industrial real estate owners, investors, and brokers to carefully understand the industry's risk and opportunities. ■

"Market Size and Demand for Marijuana in Colorado," Colorado Department of Revenue, July 2014. Grey market transactions are medical marijuana patients selling their excess product to take advantage of a tax rate differential. Recreational marijuana is taxed at nearly 25% by the state, and local municipalities may levy an additional tax on top of that. Medical marijuana is taxed at 2.9%.