Attracting Cannabis Tenants
Gauging Trends for This Emerging Use in Shopping Centers

Abstract: This article discusses how the cannabis market has grown so rapidly—and why shopping center landlords and tenants still need to proceed carefully as they determine how best to reap the opportunities from this expansion. This report covers cannabis fundamentals, including the changing state-by-state legal status for medical and recreational use, growth potential, and roadblocks. Above all, it stresses how to evaluate cannabis tenants’ place in the retail real estate environment—the extremely tight, conflicting local approval/regulatory process for licenses; the extensive security requirements involved in opening and operating stores; the role of multi-state operators; design needs; and location considerations. This analysis is based in part on interviews with Mike Demetriou, President / Broker, Baum Realty; Andrew J. Nelson, CRE, Consultant, Nelson Economics; and Bridget Hill-Zayat, Esq., Attorney, Hoban Law Group.

I. Cannabis Fundamentals

A. Differences in U.S./Canadian cultivation and acceptance

Much like gambling a generation ago, more and more North Americans have come to view cannabis consumption as a matter of personal choice rather than law enforcement—and as a business with ancillary benefits for related industries. As of October 2018, it is legal at the national level for Canadian adults to distribute small amounts of cannabis-related products, but provinces are responsible for regulating distribution and sales.

There is one fundamental difference in the recent Canadian and United States experiences of cannabis: at the federal level in the U.S., it is still considered an illegal drug. That carryover from prior decades of national drug policy affects the growing efforts in states to legalize it for different purposes. As of this writing, 20 states allow cannabis use for medical reasons only, requiring a doctor’s authorization; another 11 states, plus the District of Columbia, permit it for medical and recreational use; and in only 19 states is it fully illegal. (See Map 1.)

All this activity notwithstanding, the legal and locational issues surrounding cannabis in a retail real estate setting are significant. Cannabis continues to come up in leasing conversations because it represents a youthful enterprise that is still growing. Illicit U.S. demand is expected to drop 11% from 2019 to 2025, yielding a difference of $6.7 billion that is anticipated to be cannibalized by legal sources. Growing acceptance of this longtime “Schedule 1” drug (i.e., one with no medical value but great potential for abuse) may even result in a pie that is expanding rather than being cut into ever smaller pieces.

Key Takeaways

- U.S. sales of legal recreational and medical cannabis are projected to grow from an estimated $8.6-$10 billion in 2018 to $25.0-$30.4 billion in 2023.
- Because cannabidiol (CBD) does not cause the high associated with the psychoactive compound tetrahydrocannabinol (or, more commonly, THC) and is seen as a possible wellness-related product, its acceptance is wider than for cannabis and its sales growth has been greater.
- More than two-thirds (70%) of retail consumers identify physical stores/dispensaries as their primary cannabis source.
- Despite restrictions in several states such as the amount of cannabis that can be purchased depending on residency, users spend vigorously on products related to it.
- To deal with co-tenancy and use clause provisions implemented years ago that could now impede leasing, landlords might need to reframe leases so that commercial cannabis is expressly listed as a permitted use.
- Multi-state operators have become increasingly influential: They pay franchise and application fees as well as taxes, while also raising the bar for quality control in such areas as branding, distribution and operations.
- The current federal status of cannabis hinders companies from borrowing from banks.
- Application and licensing fees for cannabis businesses vary widely from state to state.
- Challenges associated with marketing cannabis dispensaries include difficulties in advertising, lack of credit card data for profiling customers, and the limited feasibility of social media.
- Marketing cannabis dispensaries through e-mail holds potential.
- Four trends point toward growing acceptance of cannabis, including larger markets created from increased state legalization, public music festivals/events, heightened professionalism, and greater use of technology.

B. Estimating industry size and sales

Tracking the exact size, legal and illegal, for the cannabis market is complicated: The six-digit North American Industry Classification (NAICS) code to which it is assigned (453998—All Other Miscellaneous Store Retailers, except Tobacco Stores) contains more than 25 other categories, and this subgroup is not broken out separately by the U.S. Census Bureau. However, a major statistical resource for the industry, Marijuana Business Daily, notes that U.S. sales of legal recreational and medical cannabis are projected to grow from an estimated $8.6-$10 billion in 2018 to $25.0-$30.4 billion in 2023. Sales have already exceeded those of e-cigarettes, the Fortnite video game and Goldfish crackers combined.² (See Chart 1.)

It is important to distinguish between cannabis-related products and cannabidiol (CBD). Cannabis contains a strong amount of a psychoactive compound called tetrahydrocannabinol (or, more

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commonly, THC), while CBD does not cause the high associated with THC. Because of interest in CBD as a wellness-related product, its acceptance is wider than for cannabis and its sales growth is projected to be greater. (See the Appendix on page 5.)

C. Longer-range consumer patterns

The lack of federal recognition has impeded a precise accounting of the amount spent on cannabis. Likewise, its status as an illegal drug has left many users wary of infringements on their privacy. Nevertheless, several firms have been attempting to quantify, on an ad-hoc basis, consumer behavior and expenditures:

- **Consumer behavior:** New Frontier Data, a provider of data, analytics and business intelligence for the cannabis industry, reports that 38.4 million U.S. adults consume the substance at least once annually from either a legal or illicit source. Major shares of cannabis consumers are frequent users (59% use it at least once a week, 36% daily) and comparatively young (45% aged 25-44). For 85% of retail cannabis consumers, product quality is the most important factor in selecting sources for purchases. Moreover, brick-and-mortar stores remain crucial, as 70% of retail consumers identify physical stores/dispensaries as their primary cannabis source.

- **Consumer expenditures:** States (e.g., Illinois) have limited the amount of cannabis that can be bought depending on residency, in order to prevent buying in bulk in one state and then transporting it to another where cannabis is illegal. Even with restrictions such as this, users spend vigorously on this and related products. About half (49%) of CBD purchasers spend from $51 to $100 per month on marijuana products.

## II. Cannabis in Retail Real Estate: General Considerations

### A. Types of locations

Cannabis dispensaries have tended to locate in freestanding or industrial sites near retail real estate. Co-tenancy and use clause provisions, used to help attract large retailers years ago, remain impediments to locating in shopping centers. That may change as cannabis becomes more legally acceptable and landlords can better assess its impact on cross-traffic with other tenants. But a landlord might also need to reframe a lease so that commercial cannabis is expressly listed as a permitted use.

Among their other locations are the first floors of mixed-use projects. Urban rather than rural sites are more congenial environments, as operators can draw from a greater mass of customers and win approvals from more laissez-faire municipal governments. Facility sizes range from less than 10,000 square feet to well beyond that.

### B. Multi-state operators

As the industry has grown, multi-state operators (MSOs) have become increasingly influential. Although small and mid-size operators may resent the pressures from these companies’ aggressive expansion plans, MSOs indisputably play a role through paying franchise and application fees as well as taxes. Moreover, they enhance professionalization of their product, raising the bar for quality control in such areas as branding, distribution and operations.

MSOs enjoy an important advantage over other operators: the financial resources to endure the development process. Licenses can take more than a year to obtain. Smaller firms may find that they have no other licenses/businesses to absorb the impact of their tax bills every year. MSOs are more likely to have a cushion against this dilemma.

### C. Site selection factors

As cannabis firms consider potential dispensary sites, three factors come into play:

- **Local political obstacles:** Before anything else, a community must approve a proposal. It may restrict the dispensary from operating near schools, day care facilities, churches, and libraries. These development restrictions represent considerable barriers to entering a market.

- **Different locational strategies for medical and recreational facilities:** Medical dispensaries tend to be hidden away, but recreational-use sites are located closer to mainstream retail.

- **Outsourcing market research:** A firm from outside a community cannot assume it can perform its due diligence through the internet, software or its own staff. It needs to ally with people deeply familiar with the community’s concerns as well as with knowledge of the market’s demographics. The firm must seek the advice of real estate/regulatory attorneys and brokers.

### D. Potential challenges to locating in a shopping center

The current federal status of cannabis hinders companies from borrowing from banks. In addition, tax concerns pose legal issues. Dispensaries are affected by Schedule 280E of the Internal Revenue Code, which bars businesses from taking tax deductions or credits if they engage in “trafficking” Schedule I or II substances (like cannabis). Municipal buffer zones need to be identified so that dispensaries are sufficiently far from sensitive locations such as churches, schools, libraries, day-care facilities, and parks.

### III. Landlords and cannabis spaces: Financial, design, operational and marketing issues

Shopping center owners are understandably attracted to the possibility not only that they can convert cannabis consumers from illicit to legal use, but also that this new tenant type will change the

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3 New Frontier Data, “U.S. Cannabis Industry Market Projections Up 20% to $30 Billion by 2025” (blog post), September 17, 2019; New Frontier Data, “Hyper-Defined Consumer Targeting in the Cannabis Industry” (press release), November 6, 2019.


5 New Frontier Data, “Hyper-Defined Consumer Targeting in the Cannabis Industry.”


7 The incidence of franchise fees may vary by geography. (They do not appear as commonly, for instance, in the Mid-Atlantic.)
synergies of their current roster. Some factors are already affecting centers, while others promise to do so:

A. Financial

In recent years, the number of banks and credit unions that lend to cannabis-related businesses has risen to approximately 700. Still, it is likely that, barring an alteration in federal legislation, cannabis will continue to operate on a predominantly cash model. Cannabis companies must constantly balance the need to keep adequate cash on hand for expenses that can sometimes be considerable. Protecting both this cash and the physical dangers from producing cannabis entails heightened security costs, comparable to those for a jewelry store.

Application and licensing fees add to debits, and to the uncertainty of potential tenants and their landlords. They vary widely from state to state. Moreover, the inability to transfer cannabis across state lines compels even vertically integrated MSOs to add cultivation, processing and retail stores in every state in which they operate. Operator profit margins can be thin. With legislative and regulatory developments occurring more rapidly, the lineup of industry players is not only changing but also consolidating, with the potential for failures.

As they weigh these considerations, shopping center landlords might also factor in initial findings suggesting that cannabis facilities can boost their properties. For example, a February 2020 study by the National Association of Realtors® Research Group showed that, among their survey respondents, storefront demand increased significantly in states where both medical and recreational cannabis are legal. In Colorado, a state at the forefront of the cannabis legalization movement, demand had risen so sharply by 2017 that landlords were often charging two to three times the market rate for spaces used for cultivation or sales.

B. Design

Two design elements may prove especially useful in creating a useful image for cannabis tenants.

First, a security post where personnel can screen visitors can act as a buffer zone between the entrance and the actual dispensary. Although the additional space allotted for that purpose might increase the facility’s build-out cost, it will help ease the safety concerns of landlords and other tenants.

Second, a clear, uncluttered interior, containing features such as sleek design or distinctive wood and paneling, can create a sophisticated ambiance. That, coupled with high-end, sensory offerings, strengthens a cannabis dispensary’s case that it represents the kind of experiential retail that landlords desire—and counters potential community misgivings that a second-rate establishment is being added to the tenant mix.

C. Operations

A grow facility for cannabis cultivation, generally located off-site in more remote areas that are zoned industrial or agricultural, requires an elaborate and consistently functional heating, ventilation, and air conditioning (HVAC) system. dispensaries are more centrally located retail units. For brownies, gummies or other edibles sold, a commercial kitchen may be required. Additionally, especially in the early days after opening, when novelty is still a lure, landlords might expect more traffic than usual to the property.

D. Marketing

Landlords will also need to understand the challenges and opportunities inherent in marketing a cannabis dispensary:

- **Advertising is difficult**, as agencies will not take on business from cannabis companies because of its current status at the federal level.
- **Credit card data that could help profile consumers is also not optional**, as cannabis is a mostly cash-oriented business.
- **Social media, more feasible than regular ads, is still of limited use.** It is wide open and sometimes free. But, with Facebook restricting cannabis ads, other social media such as Instagram have emerged as alternatives. Even then, companies need to avoid targeting users younger than 21.
- **E-mail marketing** enables keeping in touch with customers.

### IV. 4 Near-Term Trends

Four trends, already visible, point the way toward growing acceptance of cannabis:

- **A bigger market will result from growing state legalization.** Even if federal approval of cannabis does not occur soon, more states are considering legalization. In 2020, up to a dozen states are scheduled to take up recreational cannabis use either in the legislature or the ballot box, including New York, New Mexico, Vermont, Connecticut, and Pennsylvania.

- **Public music festivals/events.** In states that have legalized the substance, the mainstreaming of cannabis has been promoted in venues unlike the counterculture of old. California’s Northern Nights Music Festival and Outside Lands Festival, Boston’s “Freedom Rally,” and the multistate “Cannabis Cup” expo feature the likes of upscale cannabis displays, “stoned yoga,” and cannabis wedding expos. This promotes exposure and acceptability of cannabis-related products wherever they are sold, including retail dispensaries.

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9. As of February 2019, application fees ranged from $250 (Oregon and Washington) to $60,830 (Florida), while annual cultivation license fees go from $5,000 (Alaska) to $125,000 (Maryland). Companies may also need to deal with renewal fees and special classification fees (notably in California, with 18 different types each of application and licensing fees). See Noelle Skodzinski, "Your State-by-State Guide to Cannabis Cultivation Business Application and Licensing Fees," *Cannabis Business Times*, February 28, 2019.


• **Heightened professionalism.** The growing acceptance of cannabis has not only softened the stigma long associated with it but increased its attractiveness to professionals from other fields. Beyond the visible “budtenders” who greet dispensary customers, the field is increasingly turning to scientists skilled in botany, microbiology, and chemistry, as well as managers and marketing professionals.14 All of these groups are bringing skills from their occupations into this emerging industry.

• **Technology.** As with other alternative uses, technology will play an important role in the future of cannabis tenants. This includes vape pens for more controlled cannabis doses; bio-tech breeding for strengthening particular effects; blockchain for facilitating more automated, convenient and private transactions; cannabis click-and-collect, which will not only allow for store pickup but help dispensaries adhere to age limits; and seed-to-sale programs that help record consumer demand, streamline the regulatory process and manage inventory.15

### A budding future

Shopping center owners should recognize the challenges posed by cannabis tenants but not ignore their opportunities. Cannabis is unusual among emerging uses in that it capitalizes on new technologies without unduly disrupting traditional marketing channels. That represents a reassuring element of a commodity whose mainstreaming has occurred with astonishing speed. There’s considerable potential for cannabis to be a shopping center commodity with mainstream appeal.

ICSC Research would like to thank Mike Demetriou, Andrew J. Nelson and Bridget Hill-Zayat for sharing the insights that inform this article.

### Appendix: The CBD Market—Making Its Own Long Strides

Medical and recreational cannabis, for all its dramatic growth over the last several years, has not surged as rapidly or become as widespread as another cannabinoid, hemp-derived cannabidiol (or CBD), the functional/medicinal compound in cannabis. That difference in acceptance has resulted from one legislative change (the 2018 Farm Bill) and a continuing distinction by the federal Food and Drug Administration (FDA). (CBD can be sold legally if it contains no more than 0.3% THC.)

As a result, a report released in July 2019 from market research company Brightfield Group predicts that year-over-year U.S. CBD product sales will grow from an estimated $4 billion in 2019 (already up 562% from the year before) to $24.4 billion by 2025.16

Though the FDA still monitors whether companies’ claims about CBD are correct, these products are now increasingly seen as allied to the health and wellness movement, with potential benefits including its anti-inflammatory, anti-convulsant, anti-oxidant, and neuroprotective properties.17 With full-spectrum CBD still being scrutinized by regulators, companies are looking to isolates and seed oils from CBD as the most feasible additions to health and beauty products. Among the major retailers that have begun selling CBD products are Neiman Marcus, Whole Foods Market, Sephora, CVS Health, Walgreens Boosts Alliance, Ulta Beauty, GNC Holdings, Designer Brands, and Urban Outfitters.18

The shopping center industry has noticed this intensive industry and begun to think about how it applies in properties across the U.S. Through mid-year 2019, two major mall owners (Brookfield Properties and Simon Property Group) had announced that they would open nearly 400 locations selling products containing CBD in the very near future.19

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