Cannabis Businesses and New Jersey Real Estate: The Landlord's Perspective - Part One

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With the Cannabis industry booming, commercial real estate owners and landlords are challenged with keeping up with best practices, laws, and regulations related to leasing space to cannabis businesses. The article below is the first in a series of three articles intended to help landlords navigate this evolving landscape. As with any business interest, the Porzio team strongly encourages seeking the advice of counsel prior to making any representations or entering into any agreements.

Cannabis Today – The Boom

Currently, 36 states, the District of Columbia, and 4 out of 5 U.S. territories have legalized the use of cannabis for medical purposes. In addition, 18 states and the District of Columbia have legalized cannabis for recreational use, including New Jersey. The steady growth in sales of legal cannabis in the United States has so far proven to be big business, not only for the growers and sellers, but also for owners of real estate holding inventory that may be well suited to serve the growing industry. The coronavirus was good for some industries and ruinous for others. For cannabis, 2020 was a breakout year. Legal sales across the United States hit a record of $17.5 billion, a 46% increase from 2019. The current trend suggests the projected legal sales of cannabis by 2025 in excess of $40 billion with the continued legalization of both medical and recreational cannabis in additional states.

Current statistics indicate a tremendous opportunity for growth in real estate ventures inspired by the legalization of cannabis in New Jersey. Investment trusts and other multistate real estate investment vehicles are being used to provide real estate capital for the cannabis industry including acquiring real estate for conversion or development to industrial and greenhouse buildings which are then leased to growers in the cannabis industry. Similarly, other real estate investors, even if at a much smaller scale, are likely to pursue the developing real estate opportunities surrounding the cannabis industry. New Jersey landlords can better prepare themselves for the ongoing cannabis boom by becoming knowledgeable of the potential issues that may present themselves in real estate leasing transactions with growers and sellers of cannabis.

Retrofitting Commercial Space for Cannabis Tenants

Owners of factories, warehouses, self-storage facilities, and other industrial-type facilities which may have sat idle for some time are now experiencing a renaissance in interest due, in large part, to the increased need for facilities able to be repurposed for the cultivation and processing of cannabis plants and related products. As cannabis, for both medical and recreational uses, becomes more widely accepted, spaces that can convert into retail and growing use for the cannabis industry are also likely to see increased real estate transactional activity. The opportunities presented by the legalization of cannabis to repurpose dormant space seem endless.

Cultivation Considerations

For the cultivation of cannabis products, large, relatively unobstructed spaces located in industrial-type areas able to accommodate the increased square footage needed to grow cannabis are ideal. Other critical elements include the ability to retrofit the space to allow for the climate-control systems necessary to create a high humidity growing environment, the flexibility to implement the health and safety standards targeted to minimize the possible negative effects of such a tenancy (e.g. fumes, mold) and the capacity to upgrade the electrical infrastructure of the space so that it can handle the high intensity electrical use necessary for such operations.

Power and Energy

The ability to provide sufficient electrical power to meet the demands of the tenant grower is a significant factor to consider in the retrofit process. It takes a lot of power and energy to grow cannabis. Landlords need to understand these requirements and factor costs for added utility consumption in the leased space.

Security

While tenants proposing to be engaged in cannabis operations are required to submit a detailed, comprehensive security plan to the State with its application, and, if awarded a license, they must implement the plan as represented to the State, Landlord's should consider what if any additional security measures should be implemented in the common areas of a multi-tenant building.

Terms for Cannabis Related Leases

Lease Length

So, you have the space, how long do you lease it for? Because it can cost millions to retrofit the space, where the proposed tenant operations involves cultivation and manufacturing, whether it is the landlord or the tenant who pays for the retrofit, initial term leases should typically exceed ten years to allow for the amortization of the retrofit costs. In addition, the tenant will likely want the option to renew the lease in no less than 5 year increments each and/or ensure that the lease term coincides with the term of their license to operate.

Retrofitting Space for Cannabis Businesses

Cannabis growers and other businesses have unique needs for their commercial space that may require landlords to retrofit their existing facilities. As for who pays for the retrofit, it depends on who has the available cash. Because marijuana is currently illegal at the federal level, many banks will not provide financing to buildings used by the industry. Local banks may be more willing to take the risk, along with private investors. Landlords can also use cash on hand to pay for the retrofit and bill those costs back to the tenant as part of the rent over the term of the lease.

The landlord should be careful to include language in the lease that allows the landlord to install submeters to monitor the tenant's electricity and use of other utilities. With significant monthly electricity consumption costs typical in the operation of these growing facilities, the lease must protect the landlord's profit by ensuring that utilities do not overtake the rental stream.

Particular attention should also be given to the condition in which the tenant is required to deliver the space to the landlord at the end of the lease term based upon the type of installations made by the tenant throughout the lease term. It is also important to be cognizant of any laws that require notice of cessation of operations. The tenant's installations may be so unique to the tenant's cannabis cultivation business that instead of creating value to the landlord, they create increased demobilization costs to the landlord if not properly imposed as a tenant responsibility.

Considerations for Existing Financing

In addition to the issue of how to finance the retrofit, there is the issue of what impact these tenancies will have on existing financing. Landlords must be sure to review any financing documents encumbering their property for prohibition or limitation on certain uses and the steps to be followed in order to obtain approval for new tenancies.

Triple Net Leases

One solution is to structure the lease as a triple net lease with the tenant paying base rent to the landlord. All other costs and expenses, (e.g. proportionate share of real estate taxes, insurance, utilities, and security) incurred in connection with the space would be paid for by the tenant. While gross rent structures (that incorporate these costs into the rent itself) may work with tenants in other industries, the variable costs associated with operating a cannabis cultivation facility requires that additional rent costs be accounted for.

Legal Standing

With the federal legality of cannabis operations remaining in question, landlord's should be cognizant of bank deposits made from rent received from tenants with cannabis operations.

As the cannabis infrastructure in New Jersey continues to evolve, landlords may be facing pressure to enter into new leasing agreements quickly and possibly without knowledge of the relevant information.

Click here to read part two of this series where we discuss rental rates, security deposits, compliance and more.