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Africa Current Issues

Cannabis in Africa: Higher Growth Path or Pipe Dream?

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Cannabis in Africa: Higher Growth Path or Pipe Dream?

Cannabis, long demonized as a gateway to the use of more potent drugs, is gaining traction in the medical community as a beneficial treatment for mental and physical health issues. As the list of benefits ascribed to cannabis use in its various forms grows, the economic and fiscal merits of commercial production gradually take hold in many countries, and now emerge in Africa. Regulators, policymakers, entrepreneurs and conglomerates seek to position themselves to take advantage of the surging global interest in the plant.

The global legal marijuana market is valued at USD 17.7 billion in 2019 according to Grand View Research[1]. The United Nation estimates that Africa produces more than 38,000 tons of cannabis annually. If legalized, this might add up to USD 7.1 billion to the continent's gross domestic product (GDP) and provide a material boost to employment. However, the plant remains illegal in most African countries. Both regulations and perceptions of the plant will need to change to realize its economic potential. As with the development of any new industry, the political, regulatory and economic terrain needs to be mapped. Gauging the sector's future viability requires answering several key questions:

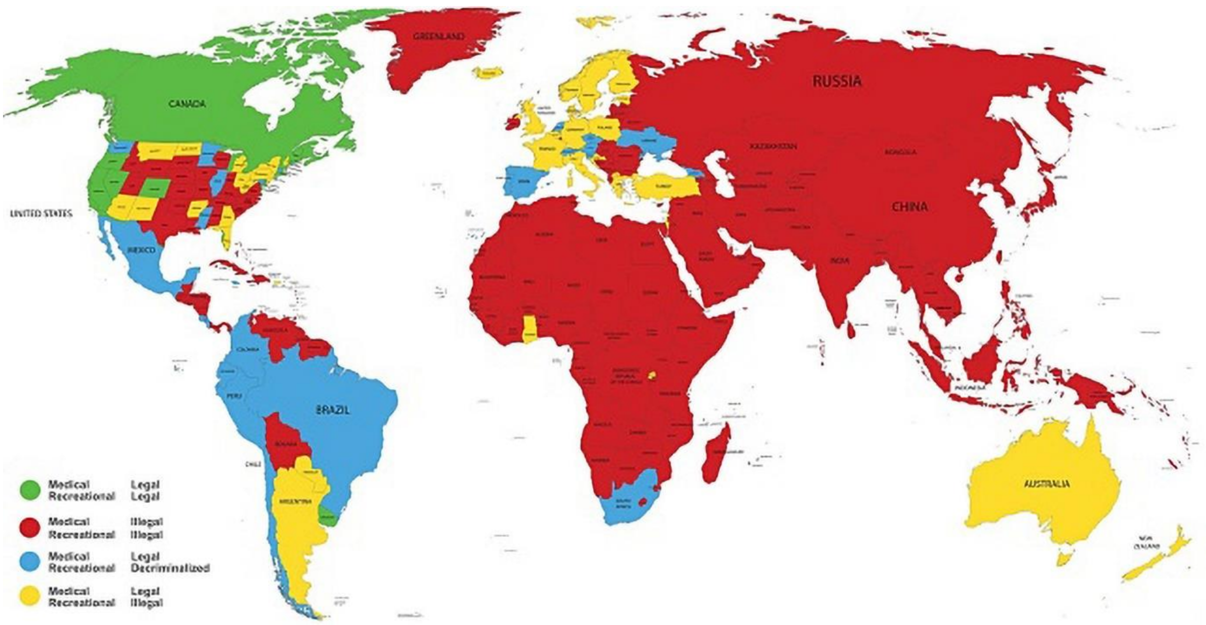
1. What is the current state of the African cannabis market?
2. What does Africa offer that few other agricultural regions can provide?
3. Which countries are best poised to take advantage of the surge in interest in the cannabis economy?
4. What needs to change for commercial cannabis production to become a meaningful economic contributor in Africa?
5. What can the experiences of other countries embarking on the cannabis journey teach Africa about how to chart the path forward?

Understanding these dynamics is critical for businesses and investors looking to verify whether the much-touted growth prospects are real and sustainable.

Background

Criminalisation of cannabis cultivation, possession and use first spread across the globe in the early 1800's and accelerated in the 1900's. This trend slowly reversed (see Figure 1), with decriminalization by Luxembourg and Canada in 2001, and eventually full legalisation from Uruguay in 2013 and Canada in 2018.[2] Much of the impetus behind the recent interest stems from decriminalization and legalisation of the plant in an increasing number of US states, the nation largely responsible for banning use of the plant across the globe.[3]

Figure 1: Legal status of Cannabis around the globe



Source: Smallcaps.com

To evaluate the potential impact of this emerging industry on African growth and industry, it is essential to understand the cannabis value chain:

a) The uses of cannabis

Apart from the psychoactive properties for which it is best known, various aspects of the plant have been used to treat ailments ranging from infections, seizures, anxiety and hypertension to nausea, inflammation, cancer and pain management.

Many early cultures cultivated cannabis for medicinal or religious use: researchers found the plant's residue in Egyptian artifacts dating back more than 4,000 years.[4] The plants contain 70 unique compounds, collectively known as phytocannabinoids. They provide three broad utilitarian components:

- THC (tetrahydrocannabinol): the compound producing psychoactive or mind-altering effects – when smoked or ingested as edibles or tinctures.
- CBD (Cannabidiol): the medically approved compound used to treat chronic pain, anxiety and inflammation, alleviate cancer related symptoms and skin ailments – when smoked, ingested as edibles or tinctures, and applied topically.
- The plant: a strain of hemp, whose fibres are used to produce cosmetics, paper and textiles, as human and animal food (hemp seeds, oils), as building materials (hemp bricks), as alternative fuel sources (biomass) and as environmentally friendly plastics (bioplastics).[5]

b) The cannabis value chain

Genetically enhanced seeds are typically developed, purchased and cultivated in either natural or artificial conditions. Once mature, the blossoms (or buds) which contain the highest concentrations of THC and CBD are picked, then stored for drying and curing. At this point, the product is ready for distribution for recreational and pain management use.

Pressing the dried flowers extracts the plant's active THC and CBD resins and oils for use in value added products such as creams, oils, edibles and pharmaceutical goods. Quality control and monitoring takes place throughout each step. The final product is then transported for inclusion into end user products (see Figure 2).

Figure 2: The cannabis value chain

Source: Medium

c) The plant's evolving legal status

The distinction between decriminalization and legalisation is important. Legalization of cannabis requires removing all legal prohibitions against its possession, use, and production. Legalization enables stricter market and quality control and makes its sale taxable. Decriminalization means that while cannabis remains illegal, the legal system would not prosecute a person for possession under a specified amount. This step does not necessarily reduce black market trafficking, and generates no revenues for the state.

d) The trend toward commercialization

Another important distinction in its commercial application is the difference between recreational and medicinal use. Typically, medicinal production and use is decriminalised first, a move that may be followed by relaxing prohibitions on recreational use. Today's growing commercialisation of the product focuses predominantly on medical applications, which offer higher margins.

1. What is the current state of the African cannabis market?

The commercialisation of cannabis crops in Africa is still in its infancy. Lesotho is the African country in the lead. The country legalised medical cannabis cultivation three years ago, and has already attracted significant funding. However, the plant's short maturation process and the relatively modest infrastructure required for growing and processing mean that other African nations should be able to quickly catch up. The primary hurdles for African countries will be the pace of enabling legislation, as well as business issues such as the capital, intellectual property and scientific resources required to improve the resulting products.

2. What does Africa offer (if anything) that few other agriculture regions can provide?

While cannabis is by nature a relatively hardy plant, it tends to flourish in warmer climes that receive abundant natural light and rainfall. Many African countries, most notably Lesotho, Swaziland, South Africa, Zimbabwe, Zambia and Nigeria offer optimal growing conditions for cannabis crops and have been at the forefront of Africa's cannabis production.

Ideal climates, however, are not sufficient to set Africa apart (some regions of the Americas and Asia offer similar conditions). Today, technological advances in grow lamps, hydroponics and genetics allow the plant to be cultivated virtually anywhere. Africa's real sources of advantages are cost, and the ability to scale.

Labour is one of the largest input costs in cannabis production. Combining low-cost labour with good growing conditions dramatically reduces production costs. Artificial indoor cultivation push overheads significantly higher due to costs such as electricity for lighting and heating, water for hydroponics and rental or property. In a telephonic interview, Sibusiso Xaba is the co-founder and CEO of Africa Cannabis Advisory Group, which helps link producers with financiers. As Xaba observed:

"The cost of production in Africa can be up to 80% cheaper (than those in developed markets)".

Africa is positioned to become a preferred cannabis production site. The continent offers lower labour, electricity and water costs, and access to large tracts of cheap, high quality arable land. African countries must now accelerate promulgation of supportive frameworks (tax regimes, investment incentives, improving the ease of doing business, and legalisation) for cannabis production and marketing. These policy moves will facilitate scaling up output and developing formal distribution channels to capitalise on currently favorable market conditions. Africa's low-cost model can then weed out higher cost producers and gain market share.

Nevertheless, African producers must still overcome significant hurdles. As outlined in the 2019 Africa Cannabis Report, much of the continent remains plagued by poor infrastructure that is likely to cap industry growth rates. Constraints such as underdeveloped road, rail and port infrastructure, combined with irregular electricity and water supplies, destabilize supply chains, increase time to market, and raise costs.

Corruption and policy uncertainty are also inhibiting factors. In countries like South Africa and Nigeria, the above factors have delayed or altogether dissuaded much needed investment in key sectors such as mining, oil and gas and telecommunications. Vested political and financial interests squabble behind the scenes for lucrative contracts or kickbacks, adding costs and delaying the regulatory and licensing process.[6] In Lesotho, two government officials responsible for issuing cannabis licenses were found to have been appointed to a company that was granted a cannabis license.[7]

Figure 3: African Cannabis industry SWOT analysis

Strengths	**Weaknesses**
• Favourable climactic conditions • Large tracts of arable land • Extensive, low cost labour pool • Relatively well established producers in the illicit market that can be brought into the formal economy • Sought-after strains of high quality product for both recreational and medicinal cannabis	• Poorly developed infrastructure (road, rail, ports, electricity, irrigation) • Weak and uncertain regulatory framework • Antiquated perceptions of the social ills caused by cannabis • Corruption • Access to capital • Poorly developed beneficiation sector
Opportunities	**Threats**
• Short time to market • Extensive tracts of under or unutilized land • The ability to scale quickly and force out higher cost producers / competition • Geographically ideal to serve fast liberalising EU market • Additional source of government and community revenue could drive wider economic development	• The impact of climate change • Perceived threat to food and water security • Reluctance of policymakers to open markets • Political instability • Not moving up the value chain to value added products –too great a focus on agricultural, rather than higher yielding manufacturing and retail opportunities

Source: Author

If Africa is to have one overarching source of advantage in the global cannabis market, it should be an organised and progressive framework to liberalise and commercialise cannabis crops. Few countries have legalised both recreational and medical cannabis use. Most have only done so for medical use. Africa has a window of opportunity to pioneer an inclusive and growth enhancing cannabis policy that would give it a jump on other regions. For this to happen, however, the staid attitudes toward cannabis among many of Africa's politicians and policymakers will need to shift. As matters stand, the pros and cons are evenly weighted, and only sustained cannabis policy coordination and government support for private sector investment will tip the scale in Africa's favour. Other countries are beginning to move in the right direction.

3. Which countries are best poised to take advantage of the surge in interest in the cannabis economy?

The Kingdom of Lesotho stands at the forefront of Africa's budding cannabis industry. It was the first country on the continent to allow cultivation. Extensive interest in the sector (particularly from Canadian investors) brought much needed foreign investment and employment to what is one of the world's poorest countries.[8] As the country has been heavily dependent on diamond revenue and trade payments from South Africa to sustain its development aspirations, cannabis has been an important revenue diversifier.

Once a market served by Lesotho, South Africa is on its way to legalising both medical and recreational cannabis use. In a country facing mounting fiscal pressures, the country's finance minister, Tito Mboweni, as a means of generating additional tax revenue, has even touted the commercialisation of cannabis crops. In his February State of the Nation address, South African President Cyril Ramaphosa outlined the government's plan to open the market:

> *"This year we will open up and regulate the commercial use of hemp products, providing opportunities for small-scale farmers; and formulate policy on the use of cannabis products for medicinal purposes, to build this industry in line with global trends".*[9]

Cannabis legalisation In South Africa could unlock R107 billion in revenue. This would boost its lagging economy and generate substantial tax revenue.[10] The country has better infrastructure and deeper investment pools than Lesotho. An expedited regulatory framework should propel South Africa to become the largest producer of medical cannabis on the continent.[11]

Zimbabwe also seeks to cash in on growing demand for medical cannabis, after decades of corruption and fiscal recklessness left the country with few reliable generators of revenue. Prohibition Partners expects the Zimbabwean cannabis market to be worth USD 80 million by 2023. Although the licensing process is underway, the country now faces a devastating drought, and suffers chronic electricity shortages. It appears unlikely to prove a more attractive investment destination over the medium-term than Lesotho or South Africa.[12]

Nigeria, Morocco, eSwatini, Malawi, Ghana and Zambia are all significant cannabis producers, but its cultivation remains illegal in these countries. Until such time as a formal licensing policy is instituted and expedited, much of the production from these countries will find its way onto the black market or be locally consumed, offering few, if any, commercial opportunities. While only Lesotho and South Africa currently offer viable investment prospects, potential investors should closely monitor regulatory developments in these markets for signs of liberalisation to gain first mover advantage.

4. What needs to change in Africa for commercial cannabis production to become a meaningful economic contributor?

More than anything, Africa needs a continent-wide, coordinated policy framework establishing the parameters for the cultivation and use of recreational and medical cannabis. This is a tall order for a fragmented continent plagued by a lack of unity and common economic vision, and it is unlikely to develop over the medium term.

Aside from the disjointed stance on the legality of the drug, perceptions of its use and value vary widely, in part because of divergent religious beliefs. The narrative around cannabis will need to shift focus from the moral to the commercial. The positive economic, medicinal and wellbeing properties of the drug need to be objectively understood to outweigh the potential negatives. This is likely to take time as more reluctant governments opt monitor developments amongst their peers who are moving toward full legalisation.

An important, but often overlooked aspect of this emerging industry is that continental producers must also focus on brand development and marketing, both of which can be costly exercises. Two particularly well-known strains from Africa are the famed Malawi Gold and Swazi Gold, both of which utilise a post-harvest processing method that has added to the story and brand.[13]

This identity has made these two strains sought after by recreational cannabis connoisseurs, but carries equal weight for medical applications, although for the latter, consistent, high quality output that complies with rigorous industry standards is the highest priority. There is currently little in the way of branding and quality control in Africa (relative to more mature markets) and African producers will likely have to lure international expertise or partner with bigger companies / funders in order to meet increasingly stringent product criteria.

Establishing a strong brand identity and producing consistently high-quality output will allow African producers to secure off-take agreements and command a price premium for their product, the profits from which can be ploughed back into research and development (R&D) to ensure the sustainability of the enterprise.

In practical terms, cannabis crops are a good fit for emerging economies like those in Africa. It is labour intensive and able to absorb a good portion of the continent's largely unskilled workers.[14] Its cultivation under natural conditions is also not excessively capital or infrastructure intensive and offers the potential to move Africa's economies up the value chain from pure production to value added beneficiation of products such as cosmetics and pharmaceuticals. The downstream benefits of such a virtuous circle would be a valuable way for these economies to diversify their income streams (many of which are concentrated on a single commodity, create employment and accelerate progress toward the 2030 Social Development Goals.

5. What can the experiences of other countries embarking on the cannabis journey teach Africa about how to chart the path forward?

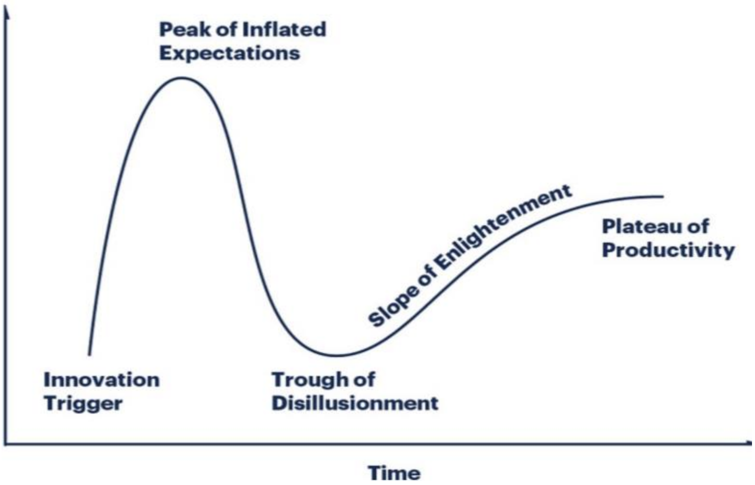
Estimates of the size, potential and demand outlook of the global cannabis market vary widely, in part due to methodology, assumptions on market legalisation, the exclusion of certain product derivatives or inclusion of illicit markets. Barclays' estimate its current worth at USD 150 billion, and indicates it could reach USD 272 billion by 2028.[15] Grand View Research estimates the market will be worth USD 73.6 billion in 2027[16] while Geneva Business News reports the number to be USD 340 billion.[17] The only certainty is that there isn't any certainty or standardization on what defines "the market".

The first (and perhaps most important) point that regulators and investors in the African cannabis industry should heed is the "irrational exuberance" that inevitably accompanies the emergence of new growth sectors. The onset of the "dot-com" era and the excitement surrounding the emergence of crypto currencies offer valuable lessons of how investors, financial markets and regulators can get burnt when over-hyped growth forecasts fail to materialise.

Already the cannabis market experienced a dose of reality when shares of listed US and Canadian cannabis stocks underwent a sharp (almost 50%) correction from pre-IPO valuations.[18] More often than not, it is the aggressive pace of projected returns that fails to materialise, rather than the forecasted benefits.

Here, the Gartner "hype-cycle"[19] is instructive (Figure 4), and boom expectations should be checked, and sustainable return timeframes pushed out. This applies equally to investors and governments.

Figure 4: The Gartner hype cycle.



Source: Gartner

Second, from a purely economic standpoint, the legalisation of a product leads to a dramatic increase in production volumes, as industry players rush in to cash in on pent up demand. In the cannabis market, with trade remaining illegal in the vast majority of countries, this leads to a large oversupply in regulated markets, which dramatically drives down prices and profitability. Producers who are now legally a part of a regulated system are unable to export to the more lucrative black market where demand still outstrips supply. Thus, the longer-term success and sustainability of the cannabis industry will depend on far broader legalisation across countries in order to smooth out regional supply and demand mismatches and bring pricing disparities into balance. Producers and early-stage investors seldom appreciate this.

The third key takeaway for operators in Africa comes from entering in any nascent market, both in terms of product and geography. The regulatory environment is new, largely untested, and therefore prone to change. For this reason, investors need to remain nimble and adaptable, able to switch product lines depending on demand patterns, adhere to shifting compliance and quality requirements, from water and land usage, to technological advancement, not just in their home markets, but in the territories they export to. Markets can open or shut on a whim. Further, new cannabis strains are constantly being developed as the industry matures to cater for evolving consumer demands.[20]

Governments too, must also ensure that mistakes of the past are not repeated. The agricultural sector in Africa has historically received little support from regulators and policymakers. Three key examples stand out:

- Ghana's cocoa industry
- Zimbabwe's tobacco sector
- Madagascar's vanilla industry

These three countries are (or were) amongst the world's largest producers of these respective crops, yet many of the farmers and producers have remained consigned to a life of poverty and exposed to wildly fluctuating prices and market forces, while large multinationals exert disproportionate influence on the industry.

If cannabis legalisation is to become a force for social and economic development in Africa, and create sustainable employment for many of its citizens and diversify export and revenue concentration, governments must establish mechanisms to promote fair trade and price practices and afford smaller scale producers equal access and protection.

As noted by Tando Matanda, founding Director of Zambezi Investment Fund notes of Zimbabwe's tobacco industry, once the fourth largest in the world:

> *"We need to make sure that Africa is not just producing the raw material or churning out commodity items that get shipped abroad with little value-addition. The agricultural trail of tobacco – pennies received for billions earned – cannot be adapted to the cannabis industry. That's something Africa cannot afford to do again."* [21]

Equitable market access starts at the licensing phase. In a telephonic interview with SAFM Radio, Agbiz agricultural economist Wandile Sihlobo highlighted how challenging market entry for smaller players can be:

> *"Right now, for example, for all of those who are getting licences, prices range around R300 000. With those prices, to acquire licences small-scale farmers in the Eastern Cape would be excluded from the market".*[22]

Not only should African governments lower barriers to entry for smaller players, but also facilitate beneficiation and value-added product exports. These moves will ensure that Africa does not once again (as with much of its mineral exports) simply become the extraction site, where the buying powers of conglomerates exploit the producers. The continent must become a downstream manufacturer of CBD oils and cosmetics with a particular focus on the production of cannabis' medical and pharmaceutical applications, which offer far higher margins and are large-scale employers. To do so, however, will require extensive funding.

This raises another important learning for Africa: access to capital, whether it be bank financing, private equity or tapping the capital markets. In more developed markets such as the US and Canada, banks are more open to providing finance not only for entrepreneurs, but for emerging sectors such as cannabis. Funding is also relatively cheap given the low interest rate environment. Private equity investors are piling into the sector, driving down funding costs and boosting company valuations. The IPO market remains relatively buoyant with more than a dozen listings in both Canada and the US, and more in the pipeline, albeit at more realistic valuations.[23]

However, access to finance in Africa has never been easy. Interest rates are typically multiples of those on offer in developed markets and funders are less sanguine on the sector, which is still seen as taboo. There is, however, growing interest from private investors and funds. Activity on the IPO market is not nearly as advanced on the continent, but is beginning to gain traction, particularly on the Johannesburg Stock Exchange (JSE) after Labat Africa Limited acquired 70% of seeds and genetic business, Knuckle Genetics, which produces high THC concentration cannabis products in Lesotho.[24]

According to Xaba, while still in its infancy, approximately USD 150 million of foreign investment for cannabis production flowed in Lesotho. Crucially, Africa is competing with South America (Colombia, Brazil, Mexico) for DM capital. The continent will have to significantly differentiate itself and make a compelling case as the preferred investment destination.

Conclusion

As to whether Africa's cannabis prospects are more hype than reality, the answer lies somewhere in-between. As has been gleaned from US and Canadian market corrections, the promise of immediate riches and benefits of cannabis production were oversold.[25] What is undeniable is that the commercialisation of the industry holds significant upside potential for the African continent, both as an employer, as well as a revenue generator.

Africa could become a dominant force in the production and development of high-quality cannabis products, if governments establish bodies (like Ghana's Cocobod) to regulate and promote the local industry, against which financing instruments could be issued (bonds), diversifying government financing options.[26]

The responsibility for realising this potential lies with the policymakers, who have the power to unlock enormous value from an industry, which is only beginning to blossom. A formalisation of the process would not only provide stable employment for those who have historically operated outside of the system, but the downstream potential from value added spinoffs (already significant) are still to be fully realised.

Importantly, investors will need to be mindful of a government's intentions behind commercialising the industry, which are squarely aimed at revenue generation, employment creation and economic development. As such, the industry is likely to receive extra scrutiny in terms of tax and quality compliance, local employment mandates and corporate social responsibility.

These are normal requirements for operating in a market that can produce high volumes and high quality at a fraction of international costs. Thus, success will depend on finding an equitable balance between attractive investor returns and fair redistribution in the form of tax compliance and economic development for local communities.

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