

Investors: It's Time to Be Cautious About Canopy Growth Corp.

Description

Since graduating from the TSX Venture to the Toronto Stock Exchange, shares of **Canopy Growth Corp.** (TSX:CGC) have been on fire.

With the exception of a tough week in the latter part of October, it's been entirely up and to the right for the stock. It has increased 127.2% in just over three months. The company now has a market value of \$899 million.

Investors are bullish, and rightfully so. Justin Trudeau's government looks poised to legalize marijuana, making Canada the first North American country to do so. Estimates are that legal pot could be a market comparable to alcohol, worth in the neighborhood of \$10 billion. Tourists would flood into Canada from the United States as millions scramble to get their hands on all the legal weed they want.

It's obvious why Canopy has become the default choice for many investors to play this boom. It's the biggest operator. There are smart people with good credentials running the show. Heck, they even have Snoop Dogg as a partner. He's an icon in marijuana culture.

Canopy is also in a business that's easy to scale up. It rents warehouses and uses them to grow pot. This capital-light business model is a good one, especially for a growth company. Canopy is all about telling investors about its growth potential. It changed its name from Tweed Marijuana to Canopy *Growth* Corp. I don't think the name choice was a coincidence.

In short, Canopy is doing a fantastic job of capitalizing on this new market. It's the investors who are getting ahead of themselves.

Warning: crazy valuation ahead

There's one huge reason why I continue to be cautious about Canopy Growth and think investors should be, too.

Its valuation is crazy. Downright insane, even.

Let's take a look at results over the last 12 months. The company did \$18 million in revenue and posted an \$8 million loss. It had cash flow of negative \$13 million, which was offset by raising \$30 million in new funding from selling shares.

Things do look better if we look at the most recent quarter. The company posted \$7 million in revenue, putting it on pace to generate \$28 million over the next year. But it still posted red ink, losing \$4 million, or about \$0.04 per share.

Profits aren't about to come either, at least according to analyst expectations on the TSX website. The company is expected to lose \$0.07 per share in 2017 and then turn a very slight profit in 2018, earning two pennies per share.

Or, to put it another way, Canopy currently trades at 361 times projected next year's earnings. That's excessive.

Canopy is expensive on all sorts of other metrics too. It trades at 6.7 times book value and more than 35 times sales. It's also issuing shares like crazy, nearly doubling the number of shares outstanding in the last year alone.

I don't want to begrudge the company for doing that, because I'd be doing the same thing if I were in charge. Canopy doesn't pay a dividend, so those shares are essentially free money. Cheap funding will help it in the future, and Canopy puts money in its back pocket with every share issued because of the discrepancy between book value and market value.

Those are all good things from the company's perspective. It's not a good thing for shareholders.

Dilution is never a good thing for shareholders. I'd expect management to issue more shares soon, taking advantage of investor enthusiasm. I sure would.

The bottom line

Canopy could very well end up as Canada's leading marijuana company. Or it could be threatened by competition from the likes of big tobacco or another business capable of throwing billions into the market. We just don't know. It's too early.

I'd be willing to make a small investment in Canopy if it were more attractively valued. It's a legit company in a sector filled with TSX Venture wannabes. But at today's valuation, it's just too risky.

An "investment" in Canopy Growth is anything but at this point. It's more like speculation.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:WEED (Canopy Growth)

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