# Canopy Growth Corp.: 3 Things You Must Understand Before Investing

## Description

**Canopy Growth Corp.** (TSX:CGC) announced its second-quarter results November 14 and, not surprisingly, revenues were up considerably over the same period last year.

Trading above $10 for the first time in its history, the bandwagon is getting pretty crowded. But before you invest in Canada's only cannabis "unicorn," it's important that you understand three things before plunking down your hard-earned retirement money.



Before I get into the three things you need to know about Canopy Growth's stock, let me first say that although I do not own the stock—I generally go for stock's growing free cash flow—I am a big believer in CGC and its place within the Cannabis industry. It has the potential to be a global player.

That said, it's crucial that investors at this stage of the game—a three-year annualized total return of 472%—carefully consider why they are making this investment and what they will do if the stock loses momentum in future quarters and falls back into the low single digits. You've got to have a plan.

Now let's get into the three things someone new to the stock needs to know before jumping on the bandwagon.

**Higher revenue, lower income**

In the first six months of fiscal 2017 ended September 30, Canopy Growth's revenue was $15.5 million—270.7% higher year over year. Yet its income from operations was $2 million, or 59% lower than in the first six months last year.

That in itself isn't unusual. Growth companies accelerate their spending as revenues grow in order to be able to meet future demand for its products. Inventories rise in anticipation of sales, etc.

However, what is different from most income statements is that gross profits are higher than revenues, resulting from changes to the fair value of its marijuana seeds and plants prior to being transferred to inventory as well as the recovery of the cost of sales of its biological assets that don't make it to inventory.

So, in the second quarter, it had $23.4 million in gains from both the fair-value change in its biological assets and the recovery of cost of sale expenses on the plants that didn't make it to inventory to offset its $18.5 million in total expenses, including cost of sales.

I would consider this "other income," which you often see in income statements, but really it's an adjustment to the income statement to reflect the changes in its balance sheet.

Until you can understand why its gross margin in Q2 2016 was 186% of revenue, you probably shouldn't be investing in Canopy stock, especially at these inflated valuations.

**Dilution**

While Canopy Growth did manage to secure a $3.5 million term loan in August from a commercial lender—a sign that Canadian banks are willing to give Cannabis producers funding—I believe that Canopy's future growth will come from bought deals like the $34 million offering completed in August.



Between the bought deal and options exercised, Canopy Growth's diluted shares outstanding increased by 8.3% in the second quarter to 112.3 million.

As it expands its business to Germany, Australia, and other countries outside Canada and takes advantage of the recreational marijuana market here at home, which is estimated to be between $7 and $10 billion annually and higher than the wine and spirits markets in this country, significant investments will have to be made in order to capture some of that market share.

Until it is generating free cash flow to buy back its shares in a significant way, investors are getting a smaller piece of a growing pie. That's not necessarily a bad thing; it's just important to understand before buying in.

**Turn more inventory**

At the end of the second quarter, Canopy Growth had $27.6 million in inventory. Its $8.5 million in revenue was just 30% of inventory, or 21% if you include biological assets prior to harvest. By comparison, **Philip Morris International Inc.** (NYSE:PM) had $7 billion in revenue in its latest quarter ended September 30, or about 88% of its $8 billion inventory.

The lack of turnover of its cannabis is a big reason why its net cash used in operating activities was $8.9 million in the second quarter—28% higher than the same quarter a year earlier.

While it might show a bottom-line profit, until it can get revenue to 50% of inventory or higher, it's going to continue to drain cash, which means more bought deals, etc.

**Bottom line**

Long term, there's no doubt Canopy Growth has great potential. Before you buy its stock, take the time to understand the path it needs to take to get to true profitability.

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