Canopy Growth Corp. Is Going to $20 Before Imploding Spectacularly

Description

Isaac Newton once said, “I can calculate the motion of heavenly bodies, but not the madness of people,” after losing his fortune in shares of the South Sea Company in the 1720s.

Of course, if Newton were alive today, he would see the same attributes of the bubble that wiped him out in Canada’s fastest-moving stock today, **Canopy Growth Corp**. (TSX:CGC). When it comes to marijuana, it’s not a matter of if, but when.

Overvalued by any measure

As a cornerstone of the party platform, the Trudeau government has pushed for legalization legislation for as early as spring 2017. Moreover, a federally commissioned task force is expected to report their findings on legalized cannabis at the end of this month.

But before you get ahead of yourselves, know that the Canopy’s underlying fundamentals have completely decoupled from the stock’s incredible market cap. Currently, analysts are forecasting the pot market to hit estimated peak sales of $5-8 billion in 2020 and beyond (including recreational and medicinal); that’s if legalization goes off without a hitch.

Canopy, on the other hand, has rallied some *350%* since August and is trading at a market cap of $1.87 billion, or 24-37% of the “dream scenario” peak market. While its growth prospects are admittedly very good (for example, its patient base increased 430% between 2015 and 2016 from 2,900 to 11,600), this market cap warrants an extremely bloated valuation that can’t be justified by even the most bullish forecasts.

Furthermore, it’s a hard and fast rule in the markets that bloated valuations ALWAYS contract. For a perfect illustration of this point, we would have to go back to 1999 to focus on a hot, new commodity that was taking the world by storm: the internet.

During the peak of the Dot Com boom (and bust), internet companies were trading at 156 times earnings on average prior to crashing spectacularly; it is worth noting that it took the NASDAQ almost 15 years to climb back to the levels prior to the implosion.

Canopy is more expensive than most start-ups

However, valuing a speculative negative earner like Canopy requires us to go beyond a simple P/E model. In this case, we will have to turn to the enterprise value (the true value of a company taking into account its net debt and minority interest) to sales multiple, which is the preferred metric used by Silicon Valley in valuing start-ups with zero earnings.

Despite fuzzy start-up math, Canopy is trading at an incredible 68 times its FY 2016 sales as of writing, putting even the most overvalued Silicon Valley unicorns to shame; that's impressive for a stock that is still cash flow negative.

valuations

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Canopy is overvalued even by Silicon Valley standards. (Source: Author generated based on company filings and CB Insights data)

And to take this comparison one step further, if we were to apply a generous 10 times sales multiple (which is the average for start-ups in the $1-2 billion range) and consensus estimates for $60 million in sales by 2018, we will have a stock with a fair value of $6 per share, or less than half of where it's trading as of writing.

That being said, Canopy is going to go up before it comes down, because irrationality supersedes prudence. If I had to guess, I would say the stock will reach $20 and a market cap well north of $2 billion before collapsing under its own weight. Did I reach this via some sort of DCF analysis or peer comparison? No, I pulled it out of thin air, because if Newton couldn't figure out market madness, then I'm not even going to bother.

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