Canopy Growth Corp.'s Margins Are About to Be Squeezed

Description

Canopy Growth Corp.(TSX:CGC) has seen its stock price climb to an all-time "high" of $17.86 last week on investor sentiment and speculation that the company will be able to continue to increase revenues and margins at higher rates than previously expected. The company's stock price has subsequently been cut in half, ending the trading day at $8.25 Tuesday.

Perhaps investors are taking money off the table. Perhaps investors saw the speculative surge and reversed their position or took advantage of the fact that the price in no way reflected reality and began shorting the stock. Or maybe investors thought about how the company's long-term margins would affect the business moving forward.

Wholesale price of marijuana appears to converge toward a lower long-term level

In Colorado, where marijuana has been legalized for recreational use for a few years, we now have data on how the market price of marijuana appears to move over time. In recent months, the price of marijuana in Colorado has been volatile and has dropped to its lowest price per pound ever.

In August, the average price per pound hovered around the $2,400-2,600 level. In September, the price per pound dropped to the $1,400-1,200 level, according to data from Tradiv, an online marijuana distribution platform.

That's a drop of approximately 50%.

Free market at work

This massive drop in the price of marijuana occurred for a number of reasons. Among these is the increased competition among new players in the marijuana production and wholesaling business, existing growers ramping up production, causing a supply/demand imbalance, and an unlimited ability for marijuana producers to produce.

In other words, licensed producers can produce as much as they want, new players have come into the market in droves (although the number of licenses has been capped as of May), and the demand for marijuana has not changed substantially.

The free market is at work–and has spoken in Colorado. In Washington State, the story is very similar. It appears that in places where marijuana is legal and traded on a free market, prices are starting to revert to a longer-term mean price.

The problem is, this new retail price level is eating into the margins of producers, who end up either taking the hit or consolidating other, smaller producer licenses to lower their average cost of production.

Either way, stock prices for publicly traded companies in Colorado have been on a similar decline to Canopy. Take a look at Denver-based **United Cannabis Corp.** (OTC:CNAB).

Vertical integration, upstream marketing, and product development may help

In the company's most recent financial statements, Canopy announced it will be trying to increase margins through "vertically integrated products" such as oils and other retail products. While these products will certainly help, many are still pending government approval.

Kudos to Canopy for getting ahead of the curve.

Investors in Canopy may take credence in the fact that the Canadian government has a track record of sheltering Canadian producers. If the Canadian government decides to protect the marijuana industry, as it has done with the dairy industry (quota system) and healthcare system (single-payer government-run system), investors may still do okay. Otherwise, the company will be in serious need of innovation, product development, and marketing moving forward.

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Date
2025/08/05
Date Created
2016/11/23
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