Read This Before Investing in Any Marijuana Stocks

Description

Investors are collectively going gaga over Canada's still-burgeoning marijuana industry.

There's one simple reason why. They see a massive potential market for legalized pot. According to one estimate, the size of Canada's marijuana market could be north of $20 billion per year, although I've also seen other analysts predict the size of the market is closer to $8-12 billion.

Still, that's a massive opportunity.

Marijuana used to be taboo, used only by young folks and people with a drug problem. Things are different these days. A recent poll showed more than 20% of Canadians smoked pot in the last year, and more than 30% responded they'd be interested in trying the drug if it was made legal. Additionally, almost 60% of respondents indicated they supported legalization in some way.

The federal government also supports legalizing weed. The Liberals are currently studying the issue and hope to have some sort of legislation on the table in 2017 or early 2018. Investors are quite optimistic something will get done relatively soon.

This all sounds like very good news for the sector. But that doesn't mean Canada's leading pot stocks are necessarily a screaming buy.

Separating fact from hype

I'm not denying the fact that a legal recreational marijuana market in Canada could be massive. What I am questioning is the price investors will pay to participate.

Take **Canopy Growth Corp.** (TSX:CGC), the largest medical marijuana company in Canada today. Shares have a market cap of $1.24 billion despite doing just $24 million in sales over the last 12 months and $8 million in its most recent quarter. The company currently trades at 48 times revenue. Not earnings. Revenue.

That makes Canopy one of the world's most expensive stocks.

Bulls argue that Canopy's valuation doesn't matter. The company is poised to be the leader in a rapidly expanding industry. The potential factor far outweighs the sky-high valuation. In other words, buying Canopy today is like buying **Amazon** in 1997 or **Wal-Mart** in 1972.

But there are a few problems with that line of thinking. First of all, it's best to buy something when the hype machine isn't on overdrive. Purchasing Amazon in 1997 would have been great. Buying it in 2003 when everyone hated tech would have been better.

And that attitude implies there are only two choices: buy Canopy or miss out. In investing, there's always a third choice. You can buy something else.

How about other marijuana stocks?

Canopy has become the go-to name in the sector. Investors like that it has graduated to the TSX after spending years on the Venture Exchange. It also has plenty of liquidity.

Other than Canopy, pickings are somewhat slim. Many of Canada's pot stocks are so small they haven't even made it to the Venture Exchange. They trade on the Canadian Securities Exchange.

Mettrum Health Corp. (TSXV:MT) is a decent-sized marijuana company with a market cap of $335 million. It has just agreed to be acquired by Canopy in an all-stock deal.

Organigram Holdings Inc. (TSXV:OGI) is another reasonably sized pot company with a market cap approaching $300 million. The Moncton-based company is the only producer located east of Quebec, benefiting from low power costs in the region.

The company is cash flow positive, which is a rarity in the sector. It has grown revenue sharply, increasing the top line from just over $13,000 to $1.8 million in just seven quarters.

But like Canopy, Mettrum, and so many other marijuana stocks, Organigram is incredibly expensive using traditional valuation methods.

The bottom line

Ultimately, it comes down to this.

There's a ton of potential in Canada's still-young marijuana business. Recreational pot will be big, which will help drive medical marijuana demand.

But it's just too early to see who's going to be the big winner in the sector. It sure looks like it'll be Canopy Growth Corp., but there are still a million things that could go wrong. To borrow a baseball analogy, it would be like declaring a game over after a 2-0 lead in the first inning.

If you insist on making an investment in the sector, limit it to a small part of your portfolio. It's just too risky to be more aggressive.

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