How Stock Options and Warrants Will Hinder Marijuana Companies Over the Next 3 Years

Description

The "green rush" bull market for cannabis and cannabis-related companies may only be getting started. Companies such as **Canopy Growth Corp.** (TSX:WEED), **Aphria Inc.** (TSX:APH), and **Aurora Cannabis Inc.** (TSXV:ACB) have seen valuations sky rocket over the past year; most marijuana companies have seen at least 200% growth over this rather short time.

The question is not whether the bull rush is over or getting started, but rather, what speed bumps or hiccups could these Canadian cannabis leaders encounter in the quarters and years ahead?

We have seen the impact the recent pesticides scandals affect Canopy (for product produced by Mettrum Ltd., a wholly owned subsidiary of Canopy) and **Organigram Holdings Inc.**, another smaller Canadian cannabis producer; these scandals have slowed down the lightning-speed advances of these company's stock prices for a short time.

I'll be taking a look at another major consideration long-term investors should take note of: stock options and warrants.

Marijuana companies (and all companies in high-growth industries) generally have two major temptations early in their life cycle:

1. They could raise money for working capital and capital expenditures through continuous rounds of equity financing at higher share prices.
2. They could give management and employees share-purchase options or give investors stock warrants with equity issuances to bring the best talent on board for the team and ensure the maximum amount of capital is raised up front.

Speaking to the first point, studies have shown that companies tend to raise money when they perceive that the valuation the market has provided for their company exceeds their intrinsic value. Typically, when a secondary equity issuance is announced, the stock price drops due to the idea that the issuance itself signals to the market that the share price for the equity portion of the firm is overvalued.

Adding more shares to the existing pot dilutes the value of existing shares — another consideration which usually contributes to a decrease in the overall share price, at least for a time.

Irrespective of whether or not additional equity issuances dilute the existing pot of shares or signal to the market potential overvaluations, the share prices of these companies have continued to rise as the increases in the market capitalizations have outpaced any detracting factors.

Over time, should equity issuances continue at the current pace, the addition of new shares will begin to take its toll on earnings-per-share (EPS) metrics and other key metrics analysts use to value the equity portion of a more mature company, leading to potential share buybacks or dividend increases down the road (both of which are highly dependent on free cash flow generation and balance sheet health).

Speaking to the second point, the existence of large-scale employee stock options and talent-inducing incentives reek of similar tactics used in high-flying tech companies looking to attract talent from a relatively narrow base. I remain unconvinced that these incentives are necessary for management or employees, considering the nature of the business. Instead, I view these compensatory tools as "patronage" payments for early stage employees and as costly and unnecessary.

Stay Foolish, my friends.

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