Top 5 Reasons 1 Marijuana Industry Expert Believes Cannabis Stocks Are Overvalued

Description

I will be looking at a recent research report by Chris Damas, an analyst at BCMI Research. Damas goes into detail about some of the key fundamentals relating to supply and demand with respect to marijuana companies that he believes are sure to lead to massive declines in stock prices sooner rather than later.

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New IPOs have resulted in large-scale venture capital

Mr. Damas refers to many of the reverse-mergers and initial public offerings (IPOs) on Canadian exchanges today as “publicly listed venture capital.” Having companies raise money via private placements and initial investors receiving larger-than-normal returns is commonplace. When the venture capital fundraising is done for publicly traded companies, the returns seem abnormal and market hysteria can take hold.

He notes specialty pharmaceutical stocks or biotechnology stocks decades ago were popular and became largely overvalued on an industry-wide level for the same reasons we are seeing cannabis stocks trading at premiums today.

Potential market size too small to satisfy potential supply

Another key indicator the market is overvalued is the fact that, according to Damas’s calculations and models showing what the market size of legalized marijuana will be in Canada, the market will not be big enough to support the amount of supply that is likely to hit the market.

A glut of supply, or as Damas calls it, “a lack of supply discipline,” is what may turn out to potentially be very damaging to marijuana prices in the medium to long term.

Major players expanding at breakneck speed

The three major players, **Canopy Growth Corp.** (TSX:WEED), **Aphria Inc.** (TSX:APH), and **Aurora Cannabis Inc.** (TSXV:ACB) are all expanding production in a major way:

- Aphria is adding another 900,000 square feet of greenhouse space in Leamington, ON
- Aurora is adding another 800,000 square feet of production space
- Canopy is planning to add another 300,000 square feet of production space to its existing base of 650,000 square feet

Taken together, the industry is expected to have over 3.5 million square feet of production space in place, producing far more cannabis than what is projected to be needed inclusive of both recreational and medical marijuana users in 2018. These numbers also exclude high-quality imports already circulating in the Canadian market.

Production becoming more efficient

The real game changer, according to Damas, is the introduction of Aurora's new "Aurora Sky" production facility, which claims to be able to produce, upon completion, 100 tonnes of cannabis per year from an 800,000-square-foot facility.

Aphria claims to be able to grow one kilogram of cannabis per 15 square feet of space. This initiative would allow Aurora to be able to produce one kilogram of cannabis with only eight square feet of space.

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With producers already competing on production design and doubling the production efficiency at current levels, the threat is clear: oversupply is imminent unless something happens.

Regulation or production cuts necessary for profitability

With supply issues already becoming apparent, Damas believes only two options are realistic for cannabis companies: (1) producers cut production levels to avoid across-the-board massive drops in marijuana prices; or (2) producers accept a deal with the provincial governments to sell marijuana at government locations and be taxed at rates similar to those of alcohol (around 80 cents of every retail dollar).

How do I like the options? I don't. Either way, Damas points out that profitability will deteriorate, and future free cash flows will not support current valuations.

Stay Foolish, my friends.

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