This Is the #1 Reason Why Marijuana Stocks Can Still Go Higher

Description

Marijuana stocks have been the best-performing sector on the TSX over the past year, making companies such as **Canopy Growth Corp.** (TSX:WEED), **Aphria Inc.** (TSX:APH), and **Aurora Cannabis Inc.** (TSX:ACB) popular subjects for debate at cocktail parties.

With legislation proposed that would have recreational marijuana legalized in Canada by July 1, 2018, there are still a lot of unanswered questions as to what the new industry will look like when it finally emerges.

Those who cynically point to the bursting of the tech bubble in late 2000 as the reason not to invest in pot stocks fail to appreciate that while many were caught off guard by overly optimistic valuations implied in internet stocks, like pets.com, others who made investments in the "winners" of the internet boom walked away with profits greater than they ever could have imagined. Imagine buying shares of **Amazon.com, Inc.** for $18 per share in 1997.

So, what is the number one reason why there is still plenty of room for marijuana stocks to go a lot higher?

By taking a quick look at other "sin" industries, like tobacco and alcohol, we can see clearly that the market has yet to fully appreciate what the "winners" of the marijuana market will look like in even just five years.

Some will point out that marijuana is a commodity, suggesting that this fact will make it difficult for marijuana companies to create a competitive advantage. Yet tobacco, like marijuana, is another plant that is relatively easy to grow and harvest. Despite this, tobacco giants like **Philip Morris International Inc.** and **Altria Group Inc.** are among the largest companies in the world, generating annual profit margins of 25% and currently receiving a six times valuation multiple for their sales in what is a mature industry.

Companies like Canopy Growth, Aphria, and Aurora Cannabis right now are enjoying a "first-mover advantage," giving them plenty of access to the capital that is required when investing in a new business. This should be expected to give them a leg up when it comes to developing a superior product and building brand loyalty.

While the first-mover advantage doesn't exactly guarantee long-term success, it certainly doesn't hurt these companies' chances either.

The Canadian marijuana retail market is expected to be somewhere between $4.9 billion and $8.7 annually according to a report from accounting firm **Deloitte**.

Within the alcohol industry, market leaders regularly capture 10% or more of the total market due to economies of scale. If these marijuana producers are able to capture 10% or even 15% of the market, it could mean yearly sales of more than $1 billion. Applying a six times price-to-sales multiple to these sales would imply valuations north of $5 billion.

Should you buy?

The current valuations of Canopy Growth ($1.47 billion), Aphria ($752 million), and Aurora Cannabis ($821 million) fail to account for the possibility that one or all of these companies will emerge as "winners" of the marijuana boom.

Using comparable valuations for profitability and market share from other "sin" industries, like tobacco and alcohol, tells us that there is in fact, very good reason why the shares of these marijuana companies can still go a lot higher.

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