Better Know a Marijuana Stock: Canopy Growth Corp.

Description

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The marijuana industry seemingly can't be stopped at the moment, and marijuana stocks are relishing the momentum.

According to cannabis research firm ArcView, North American legal weed sales, which includes both recreational and medical products, soared by 34% to $6.9 billion last year. By 2021, ArcView sees legal pot sales exceeding the $22 billion mark. Investment firm Cowen & Co. looked even further and projects $50 billion in legal cannabis sales by 2026. The changing public opinion toward marijuana — support for a national legalization has never been higher — and select state legislatures' desire to generate tax revenue from the sale of legal cannabis, have been driving forces behind its expansion.

For investors, there are dozens upon dozens of marijuana stocks to choose from. Unfortunately, with emotions running high (no pun intended), investors may be buying into weed stocks for all the wrong reasons, or worse yet, without fully understanding the risks they may deal with by purchasing volatile pot stocks.

With this in mind, we're taking the time to examine one marijuana stock each week until all the major players (those with a market cap in excess of $200 million), have been covered. Here are the marijuana stocks we've discussed so far:

- **GW Pharmaceuticals**
- **Insys Therapeutics**
- **Aphria** (TSX:APH)(NASDAQOTH:APHQF)
- **Aurora Cannabis** (TSX: ACB) (NASDAQOTH:ACBFF)

Today, we're going to take a deeper dive into **Canopy Growth Corp.** (NASDAQOTH:TWMJF).

What Canopy Growth Corp. does

Continuing with the trio of major Canadian medical marijuana player, Canopy Growth is a producer and retailer of medical cannabis products and oils in our neighbor to the north. It’s also the only other marijuana stock other than GW Pharmaceuticals to bear a $1 billion valuation for the time being.

For those who may not be aware, Canada legalized the use of medical cannabis to treat certain ailments all the way back in 2001, so there’s been a budding medical weed industry in the country for more than a decade. The company currently has six licensed facilities and approximately 665,000 square feet of production growing capacity.

Promise and opportunities

One of the primary reasons investors should be intrigued by Canopy Growth Corp. is the company’s current competitive advantage: its size. A number of the company’s peers have chosen to grow organically. This includes Aphria, which is funding its approximately $100 million Phase IV expansion to 1 million square feet of production, and Aurora Cannabis, which is currently constructing its technologically advanced 800,000 square foot Aurora Sky project. This will boost its production capacity from less than 100,000 square feet to nearly 900,000 square feet.

Canopy Growth, on the other hand, has been an aggressive acquirer. Its recently closed acquisition of Mettrum Health increased its number of licensed facilities to six, boosted its production capacity to an estimated 665,000 square feet, and gave the company two new cannabis brands with which to market. Having the highest production capacity of its peers, at least for the time being, could lend to advantages when it comes to meeting an increase in demand from Canadian customers.

It’s also worth mentioning that the purchase of Mettrum gave Canopy Growth access to about half of Canada’s medical marijuana market. More market share could lend to better pricing power, which could improve gross margin.

Another key catalyst for Canopy Growth is the expectation that Canada will legalize recreational weed. Prime Minister Justin Trudeau has championed that he would legalize recreational pot during his tenure, and he recently introduced legislated that would do just that. If approved, legal pot could be sold to any adult over the age of 21 by as early as 2018. Recreational weed legalization in Canada could add $5 billion to $7 billion in annual revenue, which is a huge pie that Canopy Growth and its other peers would want a piece of.

Also, a little over a week ago, a medical marijuana bill in Mexico was passed in the county’s lower house. With the bill passing the Senate as well, it’s just one step away from becoming law. It’s unclear if Mexico offers Canadian medical cannabis producers a large market opportunity given its history of cartels, but it represents another potential revenue channel for Canopy Growth.

Lastly, we’re seeing a pretty marked ramp-up in sales growth, likely driven by its recognizable Tweed brand and its notable partnerships, which includes strains bearing rapper Snoop Dogg’s name. Fiscal third-quarter sales increased 180% year-over-year and 15% from the sequential second quarter.

Risks and concerns

But as we’ve seen with other marijuana stocks, no company is without its risks.

One clear concern for a company like Canopy Growth is that it’s valued at north of $1 billion, yet its sales and net income don't appear to warrant such a frothy valuation, even inclusive of its competitive size advantages in Canada.

Through the first nine months of the fiscal year, sales have more than tripled compared to last year, but they total just $18.5 million. Similarly, while adjusted net income has tripled as well, it comes in at a meager $5 million over the first nine months of its fiscal year. Canopy Growth could be valued at a P/E north of 100 for many quarters to come as its acquisition-related spending and construction offsets an increase in demand for its products. Canopy Growth's valuation definitely narrows down the list of investors who'd consider investing in the company.

Political concerns are another issue that marijuana stock investors need to consider. For instance, even though Trudeau recently submitted legislation to legalize recreational cannabis, he's been suggesting he'd do so for years without any true progress. There are no guarantees that Canada will take the next step in the legalization process. Likewise, in the U.S. it's possible that the Trump administration could tighten rather than loosen federal regulations surrounding the marijuana industry in the years to come.

Canopy Growth Corp. is also facing a growing sea of competition. Once Aurora Cannabis' Aurora Sky project is finished and the Phase IV expansion for Aphria is complete (which is expected within the next year), Canopy Growth won't have a production capacity advantage over its peers.

Finally, there's the question of whether Canopy Growth can grow its business organically. It's done well with partnering and marketing its product to its medical cannabis audience, but it's grown almost exclusively through acquisitions in recent years. There's no guarantee that growth by acquisition is a sustainable long-term strategy, or that the company will have the capital to continue its aggressive acquisition spree.

Should you buy Canopy Growth Corp.?

Now for the all-important question for marijuana stock investors: Should you consider buying Canopy Growth?

On one hand, there's clear demand growth in Canada, and much of North America stands on the verge of major change (e.g., Canada possibly legalizing recreational pot, and Mexico medical cannabis). It doesn't appear that there's enough supply on the market to meet what could be a flood of demand, so that's clearly playing into the "buy" thesis, assuming Canada moves forward with recreational legalization as expected.

The company's branding efforts should also be commended. Canopy Growth has probably done a better job than any retailer in attempting to vertically integrate its business and engage its customers with recognizable ambassadors and products.

At the same time, the valuations of marijuana stocks are in the stratosphere, and Canopy Growth is no exception. Despite its rapid sales and profit growth, it could take three or more years before its aggressive valuation makes sense on the basis of forward P/E or PEG ratio.

For now, I'd suggest monitoring Canopy Growth from the sidelines until we get a definitive answer from Canada's government on recreational weed, and we see a clear improvement in its bottom-line.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:WEED (Canopy Growth)

Category

1. Investing

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