These 2 Factors Could Ruin Your Investment in Canopy Growth Corp.

Description

Canopy Growth Corp. (TSX:WEED) is now down nearly 60% off the peak established in late 2016. The recent pullback has certainly taken a large degree of risk out of the stock by deflating what was a truly absurd valuation. While the pullback represents the best entry point in months (and may very well represent a short-term bottom), investors should understand that Canopy's valuation is still extreme, and there are still many factors standing in the way of Canopy actually justifying its valuation.

While Canopy is currently a top-tier name in the cannabis space, as evidenced by its ability to maintain a nearly 55% market share (looking at its last quarter earnings as a percentage of total sector revenues), many of its risks are outside its control.

Valuation is still extreme, even after the recent pullback

Canopy currently has trailing 12-month revenue of $30 million, giving it a trailing price-to-revenue ratio of 44. Using consensus forward revenue estimates, Canopy is expected to earn $140 million of revenue in 2018 — an impressive 366% growth, and the reason for the company's lofty valuation. This gives the company what seems like a more reasonable valuation at 9.43 times 2018 revenue.

This is, however, extreme by almost every measure. **Tesla Inc.** (NASDAQ:TSLA), seen as one of North America's most overvalued names, trades at 2.75 times 2018 revenue. Of course, some may say that Tesla, operating in the relatively slow-growing automobile market, is not a valid comparison.

A more useful comparison may be technology names in the late 1990s before the tech bubble burst. These are names that benefited from the largest speculative bubble in recent history, and the vast majority do not exist anymore. Pets.com, for example, traded at 23 times trailing 12-month revenue (compared to Canopy's 44). Theglobe.com traded at 25 time trailing 12-month revenue, and etoys.com traded at 54.

Some investors may say that using backward-looking revenues like the above example isn't useful, but even on a forward basis, Canopy's valuation of nine times forward revenue has little comparison.

Canopy will face increased competition

Right now, Canopy has three major competitors, and there are 42 companies that are licensed by Health Canada to produce marijuana for medical purposes. Health Canada, however, recently stated that it is in the process of rapidly approving new producers. The government wants to ensure there is enough legal marijuana supply to meet demand and also wants to ensure there is a good mix of large and small producers.

This means that Canopy, which currently enjoys a fairly small market, will face a market that is growing in size. In addition, current projections show that by 2020, marijuana demand in Canada is set to exceed supply, and the current pipeline of supply set to come online is inadequate. This will put upward pressure on prices, which will lead to companies like Canopy either losing recreational market share to the black market or pricing coming down.

This could put pressure on long-term growth prospects for Canopy — something Canopy cannot afford at all given its extreme valuation.

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