Higher Interest Rates Make Marijuana Stocks a Riskier Investment

Description

For the first time in seven years, the Bank of Canada elected to hike interest rates in mid-July**,** lifting the headline rate by 25 basis points (bps) to 0.75%. This was a significant event for Canada's financial markets because it signifies the end of the vast sums of cheap capital that looser monetary policy provided to the business sector. The result will be higher financing costs which will ratchet up the degree of risk associated with speculative capital-intensive industries such as Canada's nascent marijuana industry.

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Now what?

According to analyst research from earlier this year, Canada's burgeoning marijuana companies have attracted about $700 million in financing since the end of the third quarter of 2016. That highlights just how dependent marijuana companies are on external funding to develop their operations to a profitable level.

In such an environment, even a modest 25 bps increase can have a significant impact on an unproven industry where participants are not only operating at a loss but need to keep investing capital to expand their operations to commercially viable levels.

You see, as financing costs rise and cash flow becomes more strained, these types of companies become less attractive propositions for investors.

Canada's largest marijuana company **Canopy Growth Corp.** (TSX:WEED) has yet to report a profit since commencing operations. Its fiscal first-quarter 2018 loss of $4.4 million was almost 13% greater than the loss reported for the same period a year earlier, while long-term debt came to just under $10 million. The recent rate hike in conjunction with the considerable degree of risk associated with Canopy's business will cause financing costs to rise and make it difficult to attain financing at economic rates. That means the company will more than likely use dilutive equity raises to obtain the capital required to develop its business and maintain operations.

Medical marijuana provider **Aurora Cannabis Inc.** (TSX:ACB) reported a first-quarter 2017 loss from operations of $1.8 million**,** which was roughly a quarter of what it had been a year earlier. While that is certainly a good sign for investors, Aurora's long-term debt of $18.7 million — almost double Canopy's — means that it has far greater exposure to the impact of higher interest rates on financing costs.

There is also the company's focus on the construction of its 800,000-square-foot Aurora Sky production facility, which is estimated to have a capital cost of $110 million. The development of that facility is to be funded from proceeds totaling $165 million that were generated from new equity and debt financing completed during the first quarter 2017. This is a huge investment for a company that is struggling to generate a profit and fund its day-to-day operations from cash flow.

The potential for cost blowouts caused by regulatory changes and operational factors is high. If that occurs, it would force Aurora to obtain more financing, which would be an additional burden on cash flow, particularly in a macro-environment weighed down by higher interest rates.

So what?

The lack of profitability and free cash flow makes these companies risky propositions for any financier. This is especially the case in an operating environment where interest rates are rising. When these factors are considered with the ever-changing regulatory landscape and uncertainty over the legalization of recreational cannabis use, it will become even more difficult for industry participants to obtain cost-effective debt finance. Those difficulties and additional costs will more than likely force marijuana companies to rely upon dilutive equity raises to get the capital required to develop their operations, further adding to the risk associated with investing in their stocks.

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