The Single Biggest Threat to the Canadian Cannabis Oligarchy

Description

As with many industries in Canada that are run in a government-owned and -operated fashion, having a distribution/retail government monopoly on cannabis in key markets such as Ontario and Alberta perhaps came as little surprise to many cannabis investors.

With only a handful of Canadian provinces and territories laying out their plans for how cannabis will be taxed, regulated, procured, and distributed to recreational users, differences across provinces as to how the psychedelic product will end up in the hands of first-time users and hardcore aficionados remains to be seen. That said, like the heavily regulated liquor distribution and retail model found in provinces like B.C., Ontario, and Quebec, Canadians should expect to pay exorbitant amounts for their marijuana moving forward as a direct result of said monopolies.

Canadians are used to the story — taxation by other means; whether we're talking about a bottle of booze, a cell phone plan, or filling up the gas tank, Canadians pay some of the highest prices in the world for goods that are much more affordably priced in countries actively focused on allowing free enterprise and competition to do their role in allowing consumers to pay market prices for goods.

Besides the retail cost argument, an argument that has not yet reared its ugly head but inevitably will (specifically in monopoly-first provinces), a key consideration for cannabis investors should be how these new systems of distribution and retail will affect their ultimate selling price. Up until now, through a network of producer-owned dispensaries and a mail-order system that appears to work just fine, marijuana producers have continued to churn out sky-high operating margins.

Losing a significant degree of control over the supply chain should be the biggest risk factor investors price in to producers today; the ultimate price **Canopy Growth Corp.** (TSX:WEED) is likely to achieve for its product can only go down after legalization — a fact that will hit Canopy's bottom line as well as its competitors across the board.

But costs are low and margins are high?

Production costs are currently very low, and margins remain high for producers across the board, making the cannabis production industry a very lucrative one long term. Sprinkle in a sky-high growth rate related to a larger available market, and it’s easy to see how the recipe for investor enthusiasm bordering on hysteria can manifest itself.

That said, companies differ in their calculations used to determine what a cash cost per gram is or how to value their inventory on their balance sheet. Accounting methods used in this industry, like in other commodities-based businesses, is difficult to understand. With the industry still in its infancy, and a lack of a concrete consensus on how costs and inventory is accounted for, plenty of room for exaggeration (and, dare I say it, manipulation) remains.

With **Aphria Inc.** (TSX:APH) posting the current record for lowest cash production costs per gram among its large peers (at $0.95, no less), companies like **MedReleaf Corp.** (TSX:LEAF) and Canopy will undoubtedly be focusing on the cost portion of the equation, given their stated cash production costs of $1.46 and $2.78, respectively, and given the uncertainty relating to the revenue side of the equation right now.

What about the long-term margin expansion expected via legalization of secondary and tertiary products?

While margins across the board may take a hit in the near term due to the introduction of government distribution networks, the argument that margins should rebound to current levels over the long term due to the ability of cannabis producers to introduce new beverages, oils, and other products carrying higher margins is an argument I find leaves lots of room for the imagination, given the stance the current federal government has taken on the secondary market.

As in other industries, in which the hand of the government is firmly placed inside the pocket of producers, investors should expect to see a slow and steady increase in taxation rates by various means impacting producers over the long term, reducing the net impact any secondary or tertiary products would have on margins.

As a cautious long-term investor, I would advise all investors to analyze cannabis producers based on fundamentals. In doing so, it becomes clear that current valuations do not make any sense.

Stay Foolish, my friends.

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chrismacdonald