



Marijuana Investors: Expect More Equity Issuances in the Near Term

Description

On Tuesday, Canadian cannabis company **MedReleaf Corp.** (TSX:LEAF) announced a bought deal offering at \$26.50 per share for a total equity issuance of an additional 3.8 million shares, including 1.9 million warrants. The deal is expected to raise more than \$100 million for MedReleaf and, in an over-allotment scenario, could fetch an additional \$15 million for the upstart cannabis company.

MedReleaf has been one of the most aggressive cannabis companies at raising equity of late, only recently completing a bought deal financing of more than six million shares at \$16.55 on December 4, raising more than \$100 million just a month prior to the announcement of this most recent equity raise. The increase in the number and size of equity issuances by cannabis firms has perhaps gone unnoticed by some investors; however, I believe this increase is symptomatic of two key underlying issues in the sector.

Share price increases are unsustainable, and companies are taking money off the table

MedReleaf is one of Canada's leading medical marijuana producers currently, and like its competitors, it has been aggressively expanding its abilities to supply recreational marijuana to the market. The company's share price has risen dramatically over the past two weeks in response to an announced deal with Shoppers Drug Mart, a subsidiary of **Loblaw Companies Limited** ([TSX:L](#)), in which MedReleaf will join competitor **Aphria Inc.** (TSX:APH) as an approved supplier of medical (and hopefully recreational) marijuana.

This increase of approximately 50% in just two weeks created a situation in which raising money at an increased valuation means issuing 50% fewer shares to accomplish the same capital inflow, making such transactions more attractive.

While they may be more attractive for companies like MedReleaf, shareholders need to remember that these continuous large equity issuances are highly dilutive and likely represent a signal to investors that the stock is significantly overvalued. Companies tend to raise money via equity markets when their stock price rises far above what it is worth; conversely, a profitable organization tends to repatriate (buy back) shares when its stock price is undervalued.

While some investors may believe that signaling is just another opaque academic principle, in this case, it is hard to argue with the numbers.

Debt financing, while increasing, is not increasing fast enough

The lack of traditional lenders (including all of the “Big Five” banks in Canada and any lender of any size) stepping up to the plate to finance the marijuana industry has caused a headache for executives in charge of growing Canada’s cannabis companies into dominant global players. A recent study of the total capital raised by the marijuana sector (dating back to mid-2017) shows that only 21% of all capital raised by cannabis producers was done via debt; the remaining 79%, or approximately \$625 million, was raised via equity issuances.

The inability or lack of willingness for lenders to do what they do best in the cannabis industry should be considered a warning for equity investors. If a bank won’t lend money to a company, why should you lend (invest) your money to help a company grow? The question is more complicated than it is at first glance. The lack of non-dilutive capital in the industry will eventually become an issue as companies continue to require additional capital.

Bottom line

Fundamentally, I prefer MedReleaf’s business model over some of its competitors. That said, like its competitors, I have grown increasingly wary of the volume and size of equity issuances in recent months. Perhaps you should, too.

Stay Foolish, my friends.

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Date

2025/08/02

Date Created

2018/01/11

Author

chrismacdonald

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