The Cannabis Sector Is Ready for an Implosion: 1,500% Acquisition Premiums Make No Sense

Description

With most Canadian cannabis producers now swimming in a sea of "funny money," some funny math has taken over in the acquisition metrics used by firms such as **Aphria Inc.** (TSX:APH) in agreeing to buy Broken Coast Cannabis Inc. for $230 million on earlier this week, as covered by fellow Fool contributor Joseph Solitro.

While Mr. Solitro appears to be very bullish on the long-term prospects of Aphria following the announcement of this acquisition as well as a couple of other recent strategic moves made by Aphria, looking at the multiple paid for Broken Coast, I'm surprised the stock didn't tank the minute the acquisition was announced.

According to Chris Damas of BCMI Research (one of the most reputable sources on the industry and the metrics behind the cannabis sector), Aphria has valued Broken Coast's productive capacity at more than $5,200 per square foot, while comparable production capacity has been built from scratch for approximately $333 per square foot.

In other words, Aphria just paid 15.7 times more than what it could have paid if it decided to buy land and build a production facility from scratch.

This isn't even the most ridiculous valuation metric one can ascribe to the deal; taking into consideration how much Aphria just paid for access to Broken Coast's loyal customers, an easy $23,000 per patient was paid to Broken Coast for the honour of selling pot to each of its customers! While other firms, such as **Canopy Growth Corp.**, have paid more on a per-patient basis for other acquisitions (as high as $26,000 per patient), seeing these numbers makes my eyes water, as I consider how much pot must be sold to these customers over time to make up the exorbitant acquisition cost taken on the backs of Aphria equity holders.

Bottom line

The argument that Aphria is doing the right thing in issuing shares ($220 million out of the $230 million will come from new equity) to acquire firms requires some funny logic in addition to the funny math. The logic goes:

- A first-mover advantage is the only important thing cannabis companies should be shooting for right now.
- The amount paid for an acquisition really doesn't matter, as the share price will continue to climb, and marijuana producers can simply issue new shares at higher prices, diluting the current shareholder base by smaller amounts over time.
- Productive capacity is somehow worth 15 times more today than it would be in one or two years from now.

The math and the logic make no sense whatsoever. When money is free and valuations continue to go to new ridiculous levels, fundamentals mean less and less. Who knows when the sector will implode, but I can tell you, I will never step foot in this sector in 2018 and beyond, until fundamentals show some semblance of reality.

Stay Foolish, my friends.

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