



Broken Coast Cannabis Inc. Bets Heavily on Aphria Inc.'s Business Model

Description

We all know cannabis stocks are hyper-volatile with the slightest piece of news, good or bad, sending them higher or lower. They've come so far, so fast; swings of 15-20% in a single day's trading is the norm right now.

It's for that reason that it didn't faze me in the slightest that **Aphria Inc.** (TSX:APH) lost 20% over two days after announcing its second-quarter earnings January 10 on concerns that production costs were rising — a potentially fatal piece of news when you market yourself as one of the lowest-cost producers in Canada.

Equally unremarkable was Aphria's 20% gain January 15 on news it is acquiring Broken Coast Cannabis Inc. for \$230 million, a premium cannabis producer based in Ladysmith, B.C.

If this were a baseball game, Aphria would be in the second or third inning with a lot of pitches and at-bats yet to come. In other words, it's best not to get too high or too low whenever news hits as it has in recent days.

Here's what interests me about these two pieces of news.

The bad news

Fool contributor David Jagielski wrote January 13 that Aphria's results weren't nearly as impressive as company boosters would like to believe.

"A closer look at the results reveals that the quarter was not as impressive as it appeared," [stated](#) Jagielski. "The company's 'all-in' costs of dried cannabis per gram were \$2.13, which is a 32% increase over the \$1.61 per gram that Aphria averaged in Q1."

He then goes on to remind investors that the company's net income only improved as a result of non-operating line items. No wonder its stock dropped 20% over two days on more than 18 million shares traded.

Aphria investors, don't despair.

First, the company spent almost \$1 million in additional funds during Q2 2018 on marketing — costs that are necessary if it's to build brand loyalty heading into legalization on July 1. If it doesn't spend the money, chances are good it won't keep growing revenues by 40% on a sequential basis.

As for the higher "all-in" cost, you could look at it similarly to the wine industry, where individual vintages produce superior grapes and ultimately better wine. Conversely, have you ever gone into the grocery store and thought the vegetables on display looked a little worse for wear? Not every plant that gets produced is going to be a winner.

CEO Vic Neufeld's job is to ensure that this type of scenario rarely happens.

The good news

You see this a lot in the tech industry, but sometimes acquisitions are less about the company and more about the talent working there. Neufeld is trying to build a deep bench; acquiring Broken Coast does just that.

"Broken Coast has proven that you can grow premium quality cannabis, charge a reasonable price and earn a profit all at the same time," said Neufeld in the company's press release announcing the deal. "Our two companies are closely aligned, particularly as it relates to our relentless focus on production costs and profitability."

Broken Coast is the 12th licensed producer in the Canadian cannabis industry with almost five years of operations under its belt and a penchant for delivering quality products at a low price.

That's vital.

Bottom line on Aphria's latest moves

Only \$10 million of the ultimate purchase price was paid in cash with the remaining \$220 million in Aphria shares valued at \$15.09 each.

Sure, you can argue that most of the deals taking place in cannabis primarily involve the issuance of stock, so the fact Broken Coast is taking 96% of the purchase price in shares is not in any way indicative of its opinion of Aphria's ability to capture market share.

However, we're talking about 14.6 million shares issued for a gain of approximately \$44 million in just one day's trading. You'd have to be crazy not to take your payment in stock, because it gives you greater liquidity while also partnering with one of the country's biggest operators.

To me, this is a win/win deal for both parties, and it's possibly more important than even the **Constellation Brands Inc.** investment in **Canopy Growth Corp.**, because it gives Aphria a beachhead out west.

The big picture looks good, but we're still in early days.

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