In the Battle of Cannabis Producers vs. Government Retailers, Who Wins?

Description

With legalized marijuana recent set to become the most privately produced and publicly retailed in Canada, questions as to just who will be raking in the profits post-legalization have begun. As of now, margins for producers remain high, and most producers are focused on increasing production capacity while lowering all-in production costs in a bid to become simultaneously fast growing and highly profitable.

What we have witnessed with recent acquisitions is an environment in which consolidation comes at increasingly steep premiums; industry leaders such as **Aurora Cannabis Inc.** (TSX:ACB) and **Canopy Growth Corp.** (TSX:WEED) will need to prove a few things to investors. First, that the price paid for recent acquisitions will make sense in the long run. Second, that scale-focused acquisitions will result in some level of synergies, either on the cost side of the equation or in building a durable competitive advantage based on market share. And third, that higher profitability levels will justify the short-term acquisition costs over the long haul.

Aurora's recent acquisition of **CanniMed Therapeutics Inc.** (TSX:CMED) is one which many, including fellow Fool contributor Joey Frenette, believe came at too steep a premium. While Aurora has now overtaken Canopy in terms of market capitalization through this acquisition, the reality is that Canopy holds more productive capacity for marijuana production, meaning that much of the market cap increase that Aurora has witnessed is related to the goodwill/paper valuation bump created by this acquisition.

The concern among many, including yours truly, is the long-term risk related to how much profit cannabis producers will be able to reap in the wake of the provincial distribution and retail rollout plans put forward to date. Canada's two largest provinces have announced plans to introduce a public retail model similar to the current liquor distribution model. This model has resulted in very minimal profit margins for liquor producers and importers, with the majority of the supply chain-related profit going to the provinces for a number of reasons.

Perhaps the most important consideration is that having a single buyer for marijuana reduces supplier power in any industry (elementary Porter's Five Forces stuff). Simple economics decree that when a supplier has one customer he or she can sell to, that one customer can determine the price that he or she is willing to pay for said commodity.

Unless Canada's cannabis producers all decide to band together either through consolidation or some sort of OPEC-style pact and try to influence prices via production levels, creating shortages, etc., those provinces with government-run procurement hubs will absolutely hammer the bottom lines of cannabis producers.

Bottom line

Investors need only look at the liquor industry to gain insight into how profitability will be divided across the supply chain. My bet is that government-run procurement agencies will find a way to negotiate lower prices with producers, creating a situation in which a race to the bottom in terms of the price producers are willing to sell at will impact profitability for producers over the long term.

Coupled with the reality that, according to a report released by Statistics Canada (street price of a gram of marijuana dropped to $7.43 from $8.43 one year ago) marijuana prices are currently dropping across Canada and we have a situation whereby profitability will certainly be squeezed by the black market.

Stay Foolish, my friends.

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chrismacdonald