Why I Wouldn’t Touch Aphria Inc.’s Stock With a Barge Pole

Description

The cannabis industry is definitely something to get excited about. For Canadians, it’s a rare opportunity to obtain next-level returns over a very short period, but it’s important to be cautious and not pay up for whatever price Mr. Market is asking. Even with highly speculative securities, you still have to consider the price you pay for what you’ll end up getting.

Unfortunately, in such a rapidly emerging nascent industry, the landscape changes by a substantial amount on a week-to-week basis, unlike many mature industries, which take years or even decades to see similar changes. Thus, it’s not uncommon for an investor to change his or her thesis on a consistent basis or even throw in the towel on one particular pot stock for another whose traits have grown more attractive given environmental conditions.

Consider **Aphria Inc.** (TSX:APH), a marijuana producer with impeccable fundamentals and the ability to drive industry-leading efficiency results. As a producer of a commodity, all that matters is a company’s abilities to scale up production at a low price without sacrificing quality. As regulators are disallowing branding in the early stages, the cannabis industry is going to be akin to many traditional commodity producers.

On the surface, given the initial post-legalization environment, it may appear that Aphria is the best cannabis investment of the big four marijuana producers. However, I believe the reverse is true, as management has really been shooting themselves in the foot with recent acquisitions whose valuations don’t appear to make any sense.

Aphria purchased Broken Coast Cannabis Inc. and **Nuuvera Inc.** for $230 million and $826 million, respectively. Both moves were made when all cannabis stocks (and valuations) were in bubble territory. Sure, the industry is slated to consolidate, but it’s a process that’s going to happen over several years, not over a few weeks. Big cannabis players who remain patient and composed will have the ability to pick up smaller producers for a fraction of the price once the cannabis market violently corrects as it’s doing now.

There may be substantial synergies be realized through the acquisition of specific producers, and there may be some hesitation that a competitor may scoop it up first; however, no amount of synergies will make up for an unreasonable price, especially at these ridiculous levels. Sure, you could argue that these firms are paying up for agricultural talent, but let’s be real. Agricultural innovation is not worth nearly as much as the specialized artificial intelligence talent that many banking firms have been paying up for in recent months. There’s no comparison to be made; the prices that larger firms are paying for the acquisition of their smaller counterparts are unjustifiable.

To rub more salt in the wound, Aphria has been notified that they'll need to dispose of their U.S. assets in order to comply with rules that allow for the company to remain publicly listed on the TSX. Aphria noted that it'll divest its U.S. assets in order to do so, but given the time constraint, it's likely the company will not be able to get the most value out of each divestment it makes.

More recently, Aphria sold its interest in an Arizona-based cannabis company for US$20 million. That's a step in the right direction for the future of Aphria shares, but was a substantial amount of value destroyed? When compared to the magnitude of Aphria's recent acquisitions, I'd say it really doesn't make a difference at this point.

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