Is Now the Time to Buy Cannabis Firms as Valuation Multiples Come Down?

Description

The Canadian cannabis sector has certainly been on quite a roller-coaster ride to start 2018. With valuation multiples recently dipping from highs seen just one month ago, this sector has provided investors who have remained on the sidelines with an interesting dilemma. Is this pullback a buying opportunity, or is it a reversion toward a lower-valuation multiple level for these firms?

One interesting piece of research I would like to highlight is a study released by Echelon Wealth Partners Inc. which mapped out the average price-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) multiple of all publicly traded Canadian cannabis producers. Every producer, from **Aurora Cannabis Inc.** (TSX:ACB), **Canopy Growth Corp.** (TSX:WEED), and **Aphria Inc.** (TSX:APH) to the country's smaller venture plays in this space, has had its valuation multiples assessed. The numbers are quite interesting to observe.

Below is a chart of the monthly average price-to-forward-2019-EBITDA multiples for the Canadian cannabis sector over the past year:

Month	Multiple
January '17	12x
February '17	11.8x
March '17	11.5x
April '17	9.4x
May '17	9x
June '17	6.9x
July '17	6.4x
August '17	7.4x
September '17	7.4x
October '17	9.7x
November '17	10x
December '17	14x
January '18	22.7x
February '18	14x

What is interesting in looking at this data is considering how important valuation multiple expansion is to the stock prices of these underlying securities, given the fact that many publicly traded companies have marginal sales or no sales at all. With most companies simply too small to book meaningful increases in EBITDA, and with the majority of EBITDA continuing to be booked as a function of IFRS accounting methodologies, which allow producers to book margins of more than 100%, these multiples may also actually be unreasonably low. The true EBITDA margins of producers postlegalization, after crop values stabilize and inventory adjustments are minimized, remains to be seen.

The requirement of cannabis producers to book the fair-value increase in the inventory (marijuana plants) as assets has led to an artificial short-term bump in profitability and margins — a fact many amateur investors may not realize. With EBITDA numbers severely elevated, the valuation multiples listed above are likely to be severely undervalued, meaning investors could be paying the equivalent of decades' worth of earnings for producers that are operating in a sector which is still in its infancy, with low barriers to entry and uncertainty as to which players will come out ahead in the long term.

Stay Foolish, my friends.

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