Why This Investment Makes Sense for Aurora Cannabis Inc. Long Term

Description

Most of the recent acquisitions made by Canadian cannabis producers for smaller firms have been made at exorbitant valuation multiples that simply do not make sense. With many investors growing increasingly skeptical of valuation multiples across a number of sectors that are beginning to experience bubble-like increases in long-term earnings expectations, the recent sell-off in many cannabis stocks could rightfully be seen as warranted.

For those who believe that now may be a good time to “buy the dip” in Canadian cannabis producers, I would caution such investors on doing so until profitability and non-adjusted earnings fundamentals begin to emerge in this sector. With a number of headwinds, including strict regulations as to how recreational cannabis will be distributed and retailed to Canadian consumers continuing to be rolled out by various provinces, investors have been prudently taking money off the table, potentially waiting for legalization to be rolled out before jumping in feet first.

That said, looking at one recent investment in the sector, cannabis producers appear to be doing everything they can to gain a foothold in the distribution and retail side of the supply chain equation. The recently announced investment of $103.5 million by **Aurora Cannabis Inc.** (TSX:ACB) in **Liquor Stores N.A. Ltd.** (TSX:LIQ) is one that should be touted by investors as a good move given the need for cannabis producers to vertically integrate in this sector. Controlling more of the cannabis supply chain should be the primary concern of producers, over and above acquiring production capacity from smaller producers at exorbitant prices.

First, a number of reports highlighting the amount of supply that should be available at the time of legalization vs. how much real demand exists in the economy for a total marijuana market (medical and recreational combined) have led many, including myself, to believe that there will be a supply surplus by Q3 2018. With retailers and distributors looking to receive their fair share of the pie, acquiring or investing in companies such as Liquor Stores N.A. — a company with the ability to directly benefit from steady margins and increasing sales from launching private store networks to sell cannabis, is a far more stable model long term.

The investment Aurora has made in Liquor Stores is also a prudent one in that it allows the producer to acquire an additional 20% stake in the company over and above the 19.9% stake currently bought, in a vast retail footprint. This could provide Aurora with a first-mover advantage in the retail of recreational marijuana — an advantage that is more valuable than a first-mover supply advantage currently.

Bottom line

With the new Aurora-Liquor Stores partnership likely to create real value for shareholders, as the company will be able to re-purpose low-performing stores into cannabis retail stores in Alberta and B.C. (along with a few other states that have legalized cannabis at the state level), investors should get excited about this deal.

That said, I would reiterate caution with respect to investing in such firms until 2019 at the earliest, as a significant amount of uncertainty in this sector remains.

Stay Foolish, my friends.

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