Bearish Investors Are Betting Against Marijuana Companies

Description

In early March, the bull market celebrated its ninth anniversary. After the biggest financial crisis in decades, investors have enjoyed nine straight years of rising equity prices. In the late stages of this bull market, the marijuana industry has emerged as the latest craze. The surge began in earnest this past November.

According to the North American Marjiuana Index, which tracks the leading stocks operating in the legal cannabis industry in Canada, marijuana companies have returned a whopping 177% since November 1, 2017. The excitement and jubilation has led to record valuations, speculation, and, in some cases, gambling.

The main driver of the TSX pot rush has been the upcoming legalization of recreational marijuana in Canada. According to market research, there are approximately four million users of marijuana in Canada, and the recreational market is value at approximately $8.7 billion. Latest estimates indicate that recreational demand can reach upwards of 800,000 kg annually.

The industry has cooled as of late, as investors have begun to take money off the table, and there has been increased insider selling. The marijuana index is down about 25% from its high reached in early January. Among the most notable players, results have been mixed. Year to date, **Canopy Growth Corp.** (TSX:WEED) and **Aurora Cannabis Inc.** (TSX:ACB) have returned 5% and 16%, respectively, while **Aphria Inc.** (TSX:APH) has lost almost a quarter of its value.

The initial pot rush was fueled by the expected supply and demand imbalance. In 2016, it was estimated that the flowering capacity of licensed producers in Canada was approximately 80,000 kg and would reach approximately 100,000 kg as of the end of 2017. This represents only 20% of expected annual demand. However, licensed producers in Canada have been aggressively pushing expansion. They have also taken advantage of investor jubilation to fund significant capacity growth through the issuance of debt and equity. As of the latest report from BMO Markets, funded capacity is now in excess of one million kg. Although it will take some time to develop and reach full operational capacity, the supply and demand imbalance won’t last for long.

Have investors grown wise? Short sellers have begun to bid up the cost to borrow shares. When the cost of borrowing goes up, it is indicative of bearish investor sentiment. Marijuana companies make up the top six of the top 10 most expensive stocks to borrow. Aurora Cannabis tops the list, followed by Cannabis Wheaton Income Corp and Harvest One Cannabis Inc. It is also worth noting Canopy Growth is one of the least-shorted marijuana companies with a 0.46% short interest.

Studies have shown that there is a link between short interest and share price declines. Given the sheer number of marijuana companies listed on the most-expensive-to-short list, investor sentiment is clearly turning bearish. It is important to note that the majority of these publicly listed marijuana companies are unprofitable and are trading at valuations that far exceed expected sales. In such times of excessive exuberance, its best to stick to the industry leaders.

CATEGORY

1. Investing

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1. Editor's Choice

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2. TSX:WEED (Canopy Growth)

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