Marijuana Legalization Is Coming! Why Canopy Growth Corp. Could Go Parabolic

Description

The Canadian cannabis sector is expected to grow at breakneck speed for years to come. Some of the country's largest cannabis producers such as **Canopy Growth Corp.** (TSX:WEED) have seen extraordinary valuation multiple expansions, reflecting this very bullish sentiment as Canada approaches legalization. Investors are increasingly focusing on only the largest producers, betting that a handful of the largest and strongest companies will prevail in a battle for a global market, which is large enough to support such valuations.

Let's take a look at Canopy Growth. With its $5.5 billion market cap, it's currently the largest producer in terms of market capitalization in Canada.

Here's what the numbers say

With all of these tailwinds set to take Canopy higher in the medium to long term, the question for the astute investor then becomes whether or not shares of Canopy are trading at a justifiable level as to support growth expectations over the long term.

As the mantra goes, any company can become too expensive, so let's take a look at just how aggressively Canopy shares are trading in this current environment.

Canopy has posted revenues that have increased at a remarkable rate — the company's $21.7 million in revenue in the quarter ended December. 31, 2017 nearly tripled the tally from a year earlier ($9.8 million). This incredible growth rate in revenue is expected to continue for some time, as the company continues to bring on new capacity from its production expansion initiatives and integrates recent acquisitions into the company's business model.

Not surprisingly, the quarterly gross margin posted by Canopy has declined since last year due to increasing production costs (57.8% for the most recent quarter compared to 64% for the same quarter last year). That said, after IFRS accounting adjustments made to the value of the company's biological assets, Canopy saw a miraculous increase in its gross margin to 85.6%, which was actually less than half of the 173.7% margin posted during the quarter ended December. 31, 2016.

What investors will need to pay attention to moving forward, however, is how Canopy will be able to continue to report gains on the value of its biological assets in future quarters as its crop continues to mature. As legalization opens up new channels for companies like Canopy to increase revenues, the rate at which the company grows is likely to be more important than profitability for some time.

Bottom line

The cannabis sector has been driven much more by sentiment than fundamentals lately, with shares of Canopy continuing to trade nearly 40% below an all-time high of $44 achieved earlier this year.

That said, should legalization prove to be a significant boost to revenue growth for companies such as Canopy, I expect an overly exuberant investor base to begin again in the latter part of 2018.

Overall, for the fundamental investor interested in lower-risk long-term growth, cannabis firms should remain off the radar until such companies have a proven track record of profitability and begin to return capital to shareholders.

Stay Foolish, my friends.

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