1 Key Driver Behind Canadian Cannabis Stocks That No One Is Talking About

Description

The number of positive catalysts that have supported the valuations of Canadian cannabis producers are many. The ability for sky-high valuations and fervent consolidation to continue at prices that are approaching insanity has less to do with the future fundamentals and earnings potential of cannabis producers and everything to do with investor sentiment surrounding what has grown from a race to become the biggest player in Canada to a narrative in which Canadian cannabis producers will “own the world,” as these legalized players have a head start on other growers globally.

Companies like **Aurora Cannabis Inc.** (TSX:ACB) are racing to consolidate this industry, with billion-dollar deals continuing to shape an industry which is still in its infancy. I remain very skeptical with respect to the pace and scale of such acquisitions and tend to agree with fellow Fool analyst Joey Frenette, who believes Aurora has indeed been engaging in a strategy of “paying a dollar to get a dime.” I suppose time will tell how prudent the strategies of Canada’s largest cannabis producers will be; however, I also believe staying defensive and guarding one’s capital is a top priority in this aged bull market.

That being said, one driver underpinning the cannabis revolution that is less talked about is the idea that Canadian cannabis stocks are defensive plays. This concept is one which has become increasingly curious to me, given the present state of the sector. Some believe that legalization will provide a floor for cannabis producers, with capital inflows and loosening debt markets expected to boost the valuations of cannabis producers further.

While one of the most significant bones that bears pick with cannabis producers is the reliance of most companies on equity issuances; while stock prices remain high, such issuances may make sense; however, at some point, using debt to lever up balance sheets and ramp up production is more likely to produce greater long-term value for existing shareholders, who may become more sensitive to dilution, given the current makeup of most deals.

The defensive argument is largely based on the idea that Canadians will not stop smoking pot, and, similar to other “sin” industries, such as alcohol or tobacco, they are more likely to maintain growing levels of consumption, despite high prices or high levels of taxation — another two negative catalysts many bears point to as long-term profitability inhibitors. This may be true, and cannabis consumption may continue to grow; however, I would recommend investors consider both sides of the trade before jumping in with both feet.

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chrismacdonald