Should Marijuana Investors Eagerly Anticipate a Canopy Growth Corp (TSX:WEED) Stock Split?

Description

News on July 31 was that **Canopy Growth** (TSX:WEED)(NYSE:CGC) management got shareholder approval to go ahead with a proposed two-for-one or three-for-one stock split, and investors in the leading cannabis producer may already be eagerly waiting for this event.

It's an interesting phenomenon that investors generally view stock splits as a big positive on a stock, and I'm wondering if there could be some important information contained in this next move by Canopy.

Why a stock split?

A two-for-one stock split is effectively the same as a 100% stock dividend in that all per-share data is reduced by 50% from earnings per share, revenue per share, to cash flow per share and all. The only difference between a stock dividend and a stock split is in the accounting treatment of the two.

A stock dividend is treated as a transfer of retained earnings to contributed capital (of which Canopy has negative retained earnings), while a stock split does not affect any balances in the company's shareholders' equity account.

Management may announce a share split any time, but such a move is typically announced after a period of a protracted rise in the share price.

Among the best rationale for stock splits is the notion that the split will result in more shares outstanding tradable on the market, thereby increasing liquidity in the stock.

Further, a share split will reduce the price of a unit of stock on the public market, allowing more retail investors to jump on to the company's equity issues more "cheaply." This allows for better marketability of the units, and this is desirable characteristic for any growth stock.

Will a split lift Canopy's equity valuation?

Many investors view a stock split as a positive sign pointing to future stock price increases. However, the announcement of a stock split is usually a mere recognition that the stock has risen high enough to justify a return of the units to a lower, more market-friendly price range.

Historically, stock splits haven't been best leading indicators of future share price growth, but have rather confirmed something the market had already known — that the price has risen substantially.

One case in point is the 2:1 split for **Computer Modelling Group** shares in July 2014, and the stock has never been able to hit the $14.95 price point since then.

Very encouraging were **BlackBerry's** two splits in May 2004 and in August 2007, where the stock went on to reach all-time highs of over $147 a share by June 2008, but we know the rise in share price was not about the stock split, it was the strength of the new smartphone business.

Alimentation Couche-Tard is another good example where the strength of the business model has sustained high equity valuation. The stock price has more than doubled since the 3:1 split in April 2014. The same goes for **Canadian National Railway's** valuation, which has nearly doubled after a 2:1 stock split in December 2013.

We can therefore safely conclude that the economic strength of a company's business model is more important than a mere stock split as a predictor of share price growth.

As the marijuana sector stands, valuations are already stretched, and fears for market corrections can't be ignored. The companies need to execute well post adult-use legalization. More care should be exercised on anything marijuana related.

Investor takeaway

Even though stock splits confirm something we already know, they improve on something every investor would desire — marketability. Improved marketability is an easy sale on any ticker. Compounded with the psychological effect of the stock appearing cheaper to retail investors, there could be some valuation positives on Canopy Growth's equity.

Canopy Growth is a leading player in a sector expected to undergo violent growth over the next few quarters post October 17, and there may be some small room for further price growth in the near term.

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